The Fundamental Rights of the Shareholder

Julian Velasco[*]

Shareholders have many legal rights, but they are not all of equal significance. This article will argue that two rights — the right to elect directors and the right to sell shares — are more important than any others, that these rights should be considered "the fundamental rights of the shareholder," and that, as such, they deserve a great deal of respect and protection by law.

The history of corporate law has been one of increasing flexibility for directors and decreasing rights for shareholders. Although the law seems to have coalesced around the norm of shareholder primacy, this is not necessarily reflected in the specific legal rights of the shareholder. The role of the director in the corporation is clearly defined, but the role of the shareholder is not. This imbalance has led to the marginalization of the shareholder. A better understanding of the role of the shareholder is needed. This article seeks to advance that understanding by means of an in-depth analysis of shareholder rights. The goal of this article is to establish that the shareholder rights to elect directors and to sell shares are indeed fundamental. It will do so by demonstrating the importance of these rights from a wide variety of perspectives, including two types of doctrinal analysis as well as the three major competing theories of the corporation. Because these two rights are important — indeed, the most important — rights from almost any point of view, they ought to be respected as the fundamental rights of the shareholder.

[*] Associate Professor of Law, Notre Dame Law School. J.D., 1994, Columbia University; B.S., 1991, Georgetown University. I would like to thank the participants of faculty workshops at Notre Dame Law School, the University of Illinois College of Law, and the Central States Law School Association's Annual Meeting for comments and suggestions; Amy Coney Barrett, Matthew J. Barrett, Anthony J. Bellia, Jr., Patricia L. Bellia, Lisa L. Casey, Nicole Stelle Garnett, Michael S. Kirsch, Mark L. Movsesian, John H. Robinson, and Franklin G. Snyder for their thoughts, comments, and assistance; Dwight B. King and Patti Ogden for their expert research assistance; and Kathleen Shields Dugan and John F. Wingerter for their excellent student assistance.

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INTRODUCTION

Shareholders have many legal rights, but they are not all of equal significance. In this article, I will argue that two rights — the right to elect directors and the right to sell shares[1] — are more important than any others, that these rights should be considered "the fundamental rights of the shareholder," and that, as such, they deserve a great deal of respect and protection by law.

The history of corporate law has been one of increasing flexibility for directors and decreasing rights for shareholders.[2] This is the result of competition among the states for incorporations,[3] and has been alternatively characterized as a dangerous "race for the bottom"[4] and an efficient "race to the top."[5] Such a broad claim could not be made for the history of securities law, but there has been a trend in recent decades to limit shareholders' ability to pursue securities litigation, especially by means of class actions.[6] Although the law seems to have coalesced around the norm of shareholder primacy[7] — that the main goal of the corporation should be to maximize shareholder wealth — this is not necessarily reflected in the specific legal rights of the shareholder.[8]

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[1] In this article, when I refer to the shareholder right to "sell shares," I mean only the right to sell any outstanding shares that the shareholder already owns. The right to issue new shares belongs to the corporation itself, provided that such shares have been authorized by the shareholders in the charter. *See* DEL. CODE ANN. tit. 8, § 151(a) (2006); MODEL BUS. CORP. ACT § 6.01(a) (2004).

[2] *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1410 & n.19, 1417-20 (1985); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 415; Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35, 36-46, 57 (1966); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 255 (1977).

[3] *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 4-12 (1993).

[4] *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974).

[5] *See* Winter, *supra* note 2, at 254-58.

[6] *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 5-23, 31-40 (1996); Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1064-80 (1999).

[7] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-43 (2001).

[8] Professor Stephen M. Bainbridge distinguishes between two concepts: the norm of shareholder wealth maximization and what he refers to as shareholder primacy.

Corporate governance involves the allocation of authority to manage the affairs of the business. To arrive at the proper balance, it is important to understand the roles of the relevant parties. The role of the director in the corporation is clearly defined. State corporate codes generally provide that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[9] These provisions have been interpreted broadly to afford directors substantial authority and wide discretion. It is generally agreed that directors are the ultimate managers of the business.[10] The role of the shareholder, on the other hand, is much less clear. Although the shareholder is often said to be the owner of the corporation, that status does not result in very much power vis-à-vis directors.[11] While the law's clarity with respect to the role of the director is an asset, its uncertainty with respect to the role of the shareholder is a liability, and the imbalance between the two has led to the marginalization of the shareholder. A better understanding of the role of the shareholder is needed.

I hope to advance that understanding by means of an in-depth analysis of shareholder rights. My premise is that, although directors may be the ultimate managers of the business, shareholders also have a legitimate role in corporate governance. Thus, while shareholder rights should not undermine the role of the director, neither should director prerogative undermine the role of the shareholder. Whatever balance corporate governance may strike between them, it may not disregard the fundamental rights of the shareholder.

According to him, the former concept requires the corporation be run in the interests of shareholders, while the latter suggests that shareholders should have the final say in corporate matters. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 563 (2003). In this article, I use the term "shareholder primacy" to mean only what Professor Bainbridge would call the norm of shareholder wealth maximization; I do not defend what he would call "shareholder primacy."

[9] DEL. CODE ANN. tit. 8, § 141(a) (2006); *see also* MODEL BUS. CORP. ACT § 8.01(b) (2004).

[10] Many have argued that it is the executive officers who have the real power in the corporation. *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). This article will not explore the difference between directors and officers, but assumes that they act together as a management team, regardless of who actually is in charge. The focus of this article is on the conflict between shareholders on the one hand and the management team on the other.

[11] *See infra* Part III.

In this article, I seek to establish that the shareholder rights to elect directors and to sell shares are indeed fundamental.[12] I do not mean to suggest that these rights are fundamental rights in the constitutional law sense of being "implicit in the concept of ordered liberty."[13] Rather, my claim is that these rights are fundamental in the corporate law sense that mergers and charter amendments are fundamental transactions,[14] and in the dictionary sense that they are primary, basic, principal, and deep-rooted.[15] While these rights may not be inviolable, they are eminently worthy of respect. I will demonstrate the importance of these rights from a wide variety of perspectives, including two types of doctrinal analysis, as well as the three major competing theories of the corporation. Because these two rights are important — indeed, the most important — from almost any point of view, they ought to be respected as the fundamental rights of the shareholder.

In Part I, I compare the fundamental rights of the shareholder with her other legal rights. First, I categorize the various rights into four groups: economic rights, control rights, information rights, and litigation rights. I consider the limits of these rights, both legally and factually. I then argue that the rights to elect directors and to sell shares stand out above all the others. While most of the shareholder's rights are either ancillary or illusory, these two rights are primary and important. Thus, by their very nature, these rights are fundamental.

In Part II, I consider the fundamental rights in the broader context of the nature of corporate law. I argue that, unlike many other areas of law, corporate law is characterized by a high degree of formalism. This formalism tends to favor directors by affording them a great deal of discretion: they may take almost any action, provided that they follow the appropriate rules. However, it also provides a natural limit on the role of directors: they are authorized to manage the affairs of the business, but not the affairs of the shareholders. I argue that, because decisions regarding the election of directors and the sale of

[12] *Cf.* Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103 (2003) (discussing importance of voting and selling for role of shareholder in corporate governance); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001) (similar).

[13] Palko v. Connecticut, 302 U.S. 319, 325 (1937).

[14] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 n.8 (Del. 1985) (describing charter amendments and mergers as "traditional areas of fundamental corporate change").

[15] *See* MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 507 (10th ed. 1998) (defining "fundamental").

shares are the affairs of the shareholders rather than of the corporation, formalism should lead to a healthy respect for the fundamental rights of the shareholder.

In Part III, I consider the fundamental rights from the perspective of the traditional view of the corporation. Under the traditional view, the corporation is a separate entity owned by its shareholders. As the owners, shareholders should be entitled to do as they please with the corporation. However, corporate law has never given shareholders very much power. Therefore, I focus in this part on reconciling the traditional view with the limited role of the shareholder in corporate governance. I argue that what makes the current system work are directors' fiduciary duties to the shareholders. Despite their limitations, shareholder rights remain vitally important in the traditional view.

In Part IV, I consider the fundamental rights from the perspective of law and economics. The law and economics theory of the corporation, also known as contractarian theory, views the corporation as a "nexus of contracts" among various stakeholders. In other words, the shareholder is not an owner, but merely one type of investor among many. Despite this downgrade in the shareholder's status, contractarian theory tends to reaffirm the norm of shareholder primacy. In this part, I explain how the fundamental rights of the shareholder are important both for the benefit of shareholders as well as for the benefit of society.

Finally, in Part V, I consider the fundamental rights from the perspective of corporate social responsibility. According to social responsibility theory, the corporation should not be managed in the interests of the shareholders alone, but rather for the benefit of society as a whole. Because it is premised on the rejection of shareholder primacy, social responsibility theory clearly is less supportive of shareholder rights than the other theories. Thus, my goal in this part is modest: I argue only that social responsibility theory is not inherently inconsistent with the fundamental rights of the shareholder. I emphasize that shareholders are important participants in the corporate enterprise in order to establish that they deserve no less respect for their rights than any other participants.

By demonstrating the importance of the shareholder rights to elect directors and to sell shares from these five different perspectives, I hope to establish the fundamental nature of these rights. While this fundamentality does not render these rights untouchable, it should suggest the need for adequate protection of these rights as well as caution in allowing them to be curtailed. In short, acknowledging the

fundamental rights of the shareholder as such requires a commitment to taking these rights seriously.[16]

I. SHAREHOLDER RIGHTS UNDER EXISTING LAW

In this Part, I compare the fundamental rights of the shareholder with her other legal rights. Shareholder rights are numerous and varied. However, they are not all of equal significance; some are more important than others. In section A, I assess the various rights, considering the limits of each, both in law and in fact. Then, in section B, I argue that two specific rights — the right to elect directors and the right to sell shares — stand out above all the others. While most of the other shareholder rights are either ancillary or illusory, these two are primary and important. Thus, by their very nature, these rights are fundamental.

A. Specific Legal Rights

In this section, I categorize the shareholders' various legal rights into four groups. These are economic rights, control rights, information rights, and litigation rights. I consider each of these categories in turn.

1. Economic Rights

Shareholders invest in corporations primarily for economic gain. There are two main ways in which shareholders can profit from a corporation: by receiving distributions of the company's profits and by selling all or part of their interest in the corporation.[17] These methods correspond with the two main economic rights of the shareholder: the right to receive dividends and the right to sell shares.[18]

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[16] I will consider the implications of this thesis in a future article. *See generally* Julian Velasco, *Taking Shareholder Rights Seriously* (Notre Dame Legal Studies, Working Paper No. 06-03, 2006), *available at* http://ssrn.com/abstract=917793.

[17] In close corporations, shareholders generally also expect employment and salaries, from the corporation. *See* 1 F. HODGE O'NEAL & ROBERT B. THOMSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS § 1:9, at 1-26 to -37 (3d ed., rev. 2004). However, any such salaries are paid to shareholders only in their roles as employees, in consideration of their employment.

[18] Shareholders also are entitled to the net proceeds of the corporation upon dissolution. *See* DEL. CODE ANN. tit. 8, § 281(a) (2006); MODEL BUS. CORP. ACT § 14.09(a) (2004).

The right to receive dividends is a limited one, both in law and in fact. Legally, shareholders only have the right to receive such dividends as are declared by the corporation's board of directors. Directors have no obligation to declare dividends and may reinvest the corporation's profits rather than distribute them to shareholders.[19] Shareholders only have a legal right to the payment of dividends after, and to the extent that, the board of directors declares any.[20]

In practice, many corporations do declare and pay dividends regularly. However, most companies distribute only a modest portion of their profits to shareholders.[21] Generally, shareholders do not expect to receive the bulk of the return on their investment in the form of dividends.[22] In fact, many corporations pay little or no dividends.[23] Thus, the right to receive dividends has not been crucial for many shareholders.[24]

Shareholders also can benefit economically by selling their shares at a profit. One of the key characteristics of corporations is the free transferability of shares: shareholders can sell shares at will.[25] This right of alienation flows from the fact that shares are a form of

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[19] *See* 11 WILLIAM MEADE FLETCHER ET AL., CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5320, at 562-63 & nn.7-8 (perm. ed., rev. vol. 2003). Under certain circumstances, directors theoretically may be obligated to declare dividends. *See id.* § 5325, at 578. However, the decision of whether to declare dividends is protected by the business judgment rule. *See id.* at 586-87.

[20] *Id.* § 5321, at 563-66.

[21] Floyd Norris, *Cash Flow in '04 Found Its Way Into Dividends*, N.Y. TIMES, Jan. 4, 2005, at C1 ("[T]he companies in the S.&P. 500 paid out just 34 percent of reported profits in dividends last year, far below the historical average of 54 percent.").

[22] "In 2004, the S.&P. 500 had a total return for investors of 10.9 percent, with dividends accounting for just 1.9 percentage points of that return — or 17 percent of the total return." Norris, *supra* note 21, at C10. In close corporations, shareholders generally prefer salaries to dividends. *See supra* note 17.

[23] As of 1999, only approximately 21% of public corporations paid dividends. *See* Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3, 4 (2001). Spurred in part by the reduction of the tax rate on dividends in 2003, companies have since adopted more generous dividend policies. *See* Brian McMahon, *Back in Style*, FIN. PLANNING, Nov. 1, 2004, at 153, 153.

[24] Of course, some shareholders value dividends more than others. Shareholders on fixed incomes, such as retirees, often have a greater need for regular distributions of the company's profits.

[25] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 109 (9th ed. 2004). In closely held corporations, share transferability may be restricted contractually or by the absence of purchasers. *See id.*

personal property.[26] Share ownership does not directly impact the corporation because the business is managed by a board of directors rather than by shareholders.[27] As a corporation increases its profits, the value of its shares rises, creating a profit potential for the selling shareholder.[28] Moreover, because shareholders generally do not have fiduciary duties to one another or to the corporation, they may keep for themselves any profit that they make.[29]

The law does allow for some restrictions on the right to sell shares. To the extent that the corporation is closely held, the law may impose some fiduciary duties on a shareholder. Thus, for example, a controlling shareholder may not sell her shares to a known or suspected looter because this carries too great a risk of harm to minority shareholders.[30] In addition, federal securities law prohibits insider trading[31] as well as various forms of stock price manipulation.[32]

The law also allows the impositions of certain burdens on the shareholder right to sell shares. For example, shareholders may enter into contracts limiting their ability to sell shares.[33] More importantly, state corporate law permits directors to prevent shareholders from selling their shares in hostile tender offers by implementing takeover defenses such as the poison pill.[34] This is so even though a tender

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[26] *See, e.g.*, DEL. CODE ANN. tit. 8, § 159 (2006); MODEL BUS. CORP. ACT § 1.40(22) (2004); *see also* Thompson & Smith, *supra* note 12, at 304 ("Under the corporate law of Delaware and other states, the usual rule is that shares of stock are freely transferable. State corporations codes do not see the need to specify this basic right of property, but it is implicit in statutory provisions regulating restrictions on share transfer."). To say that the shares are the property of the shareholder is not necessarily to suggest that the corporation and its assets are the property of the shareholder. *See infra* notes 193-98 and accompanying text.

[27] In closely held corporations, the separation of ownership and management may be more theoretical than real. *See* KLEIN & COFFEE, *supra* note 25, at 132.

[28] *See id.* at 286-88.

[29] *See* Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387, 388 (N.Y. 1979).

[30] *See, e.g.*, Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1087 & n.151 (Del. Ch. 2004).

[31] *See* United States v. O'Hagan, 521 U.S. 642, 651-52, 667-69 (1997) (discussing insider trading under SEC Rules 10b-5 and 14e-3); Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006) (imposing liability for short-swing profits).

[32] *See, e.g.*, Securities Exchange Act § 9, 15 U.S.C. § 78i (2006). "Manipulation is 'virtually a term of art when used in connection with securities markets,' . . . referring to practices that are intended to mislead investors by artificially affecting market activities . . . ." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 463 (1977) (citation omitted).

[33] *See* DEL. CODE ANN. tit. 8, § 202 (2006); MODEL BUS. CORP. ACT § 6.27 (2004).

[34] *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding directors' adoption of poison pill defense).

offer is a transaction between the shareholders and the hostile bidder and technically does not involve the corporation.[35]

To be sure, directors are not given free rein. Their attempts to block tender offers are subject to review for breach of fiduciary duty,[36] although it is not clear that courts are willing to take an active role in monitoring directors in the context of hostile takeovers.[37] In addition, directors' ability to prevent shareholders from selling their shares is limited to tender offer situations: shareholders always remain free to sell shares on the open market. Thus, directors may be able to block a change in control and prevent shareholders from receiving a premium in a tender offer, but they cannot actually prevent shareholders from selling their shares at the market price.[38]

2. Control Rights

One of the key characteristics of corporations is the separation of ownership and control.[39] Although shareholders may "own" the corporation,[40] they do not have the right to manage the business. The authority to manage the business is vested in the board of directors.[41] Nevertheless, it would be wrong to conclude that shareholders have no control rights.

Shareholders have the right to vote on important matters relating to the business, which gives them some control over the corporation.

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[35] *See* STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS § 1.2.C, at 9-10 (2003).

[36] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1390 (Del. 1995).

[37] *See generally* Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 416-22 (2002) (arguing that "exceedingly deferential review has eviscerated the *Unocal* test and allowed the poison pill to become the preeminent management entrenchment mechanism").

[38] *Cf.* Chesapeake Corp. v. Shore, 771 A.2d 293, 328 (Del. Ch. 2000).

> It is . . . interesting that the threat of substantive coercion seems to cause a ruckus in boardrooms most often in the context of tender offers at prices constituting substantial premiums to prior trading levels. . . . The stockholder who sells in a depressed market for the company's stock without a premium is obviously worse off than one who sells at premium to that depressed price in a tender offer. But it is only in the latter situation that corporate boards commonly swing into action with extraordinary measures.

Id.

[39] *See* KLEIN & COFFEE, *supra* note 25, at 109-10.

[40] Not everyone accepts that shareholders "own" the corporation in any meaningful sense. *See infra* Part IV.

[41] *See supra* note 9 and accompanying text.

Chief among their voting rights is the right to elect directors, who in turn manage the business.[42] In theory, this should give shareholders ultimate control over the business. In practice, however, it does not.

It is common knowledge that individual shareholders generally are not interested in — or, at least, not capable of — exercising their control rights effectively. As Professors Adolf A. Berle, Jr., and Gardiner C. Means argued long ago, shareholders often are virtually powerless against management.[43] Because each individual shareholder owns only a very small percentage of the outstanding shares of a corporation, she does not have a stake sufficient to make monitoring worthwhile. After all, becoming informed is costly; it is also futile, because one shareholder's meager vote is unlikely to affect the outcome. Thus, shareholders tend to be rationally apathetic and support the incumbent board on the theory that the directors are experts and have access to greater information.[44]

Even if they wanted to oppose the incumbents, however, shareholders would have a difficult time. Shareholders generally do not attend shareholders' meetings, but rather exercise their right to vote by proxy.[45] Directors have control over the proxy mechanism and, in many ways, the process is stacked against the shareholders.[46] For example, the incumbent directors are permitted to use corporate funds to solicit proxies for their own reelection.[47] In order to oppose them, a shareholder would have to incur the considerable expense of a proxy contest.[48] Otherwise, the proxy rules limit shareholders'

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[42] *See* DEL. CODE ANN. tit. 8, § 211(b) (2006); MODEL BUS. CORP. ACT § 7.28(a) (2004).

[43] *See generally* BERLE & MEANS, *supra* note 10.

[44] *See generally* ROBERT C. CLARK, CORPORATE LAW 390-92 (1986) (discussing rational apathy); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526-29 (1990) (same); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1575-77 (1989) (same).

[45] *See* DEL. CODE ANN. tit. 8, § 212; MODEL BUS. CORP. ACT § 7.22.

[46] *See generally* Black, *supra* note 44, at 530-66, 592-95.

[47] This is true even in the case of a proxy contest, as long as there is a bona fide policy contest and not an entrenchment motive. *See* Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 292 (N.Y. 1955).

[48] Shareholders may vote to reimburse a successful contestant for reasonable expenses. *See Rosenfeld*, 128 N.E.2d at 293. A recent SEC proposal would allow for electronic delivery of proxy solicitation materials. *See* Internet Availability of Proxy Materials, 70 Fed. Reg. 74,598 (Dec. 8, 2005) (to be codified at 17 C.F.R. pts. 240, 249, 274). This would be helpful because it would eliminate the printing and delivery costs for an insurgent. However, it would not reduce the significant preparation and persuasion costs associated with a proxy contest.

options to either voting in favor of the incumbent directors or withholding consent;[49] they can neither vote against board-sponsored candidates nor propose alternatives.[50] In addition, state law generally provides that directors are elected by a plurality vote.[51] Under a plurality vote, the candidate with the most votes wins — even if the candidate did not receive a majority of the votes cast.[52] Under these circumstances, abstention is a meaningless gesture.[53]

Although shareholders face many obstacles in exercising their right to elect directors, the fact remains that *only* shareholders can elect directors.[54] As shareholder dissatisfaction with existing management grows, it becomes easier for someone to wage a proxy contest to convince shareholders to vote against the incumbent directors. Thus, under certain circumstances, the right to elect directors can become quite meaningful.[55]

Shareholder voting rights are not limited to the election of directors. Shareholders also are permitted to vote on certain fundamental matters. Different states subject different matters to shareholder approval, but common examples include mergers[56] and charter amendments.[57] In addition, many states allow shareholders to amend the corporation's bylaws unilaterally.[58]

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[49] *See* 17 C.F.R. § 240.14a-4(b) (2006).

[50] *See id.* § 240.14a-8(i)(8). *But see id.* § 240.14a-4(b) instruction 2.

[51] *See* DEL. CODE ANN. tit. 8, § 216 (2006); MODEL BUS. CORP. ACT § 7.28(a) (2004).

[52] *See* Comm. on Corp. Laws, ABA Section of Bus. Law, *Report of the Committee on Corporate Laws on Voting by Shareholders for the Election of Directors*, *in Changes in the Model Business Corporation Act*, 61 BUS. LAW. 399, 404 (2005).

[53] Although the power to withhold support may not prevent a candidate from being elected, a sufficiently high number of votes withheld may be seen as a vote of no confidence and could have a similar practical effect. *See, e.g.*, Ronald Grover & Tom Lowry, *Now It's Time to Say Goodbye: How Disney's Board Can Move Beyond the Eisner Era*, BUS. WK., Mar. 15, 2004, at 30 (discussing impact of elections at 2004 Annual Meeting of Walt Disney Co. where 43% of shareholders withheld support for Chairman and CEO Michael D. Eisner, leading to his replacement as Chairman). However, because any such message is not legally binding, it is up to the board of directors to decide how much effect it should have, if any. *See, e.g.*, *id.* (stating that Eisner remained as CEO and former United States Senator George J. Mitchell, an ally, replaced him as Chairman).

[54] Although corporate charters may provide otherwise, they almost never do.

[55] *See* discussion *infra* Part IV.C.2.

[56] *See* DEL. CODE ANN. tit. 8, § 251(c); MODEL BUS. CORP. ACT § 11.04. There are, however, exceptions to the rule. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 251(f) (small-scale merger), 251(g) (holding company merger), 253 (short-form merger).

[57] *See* DEL. CODE ANN. tit. 8, § 242(b); MODEL BUS. CORP. ACT § 10.03.

[58] *See* DEL. CODE ANN. tit. 8, § 109(a); MODEL BUS. CORP. ACT § 10.20(a).

The right to vote on fundamental matters gives shareholders a voice in corporate affairs. However, this voice is limited. First, shareholders generally can vote only on matters submitted to them by the directors. Shareholders can neither propose their own transactions or charter amendments, nor modify those proposed by directors. Moreover, directors often can find ways around the shareholder approval requirement. For example, a possible merger could be restructured as an asset purchase. The end result can be virtually identical, but there is no requirement of shareholder approval for an asset purchase.[59] Similarly, directors could implement a charter amendment during a merger toward which the shareholders are favorably inclined:[60] shareholders would be required to accept the charter amendment in order to obtain the benefits of the merger. Shareholder bylaw amendments may not be subject to the same kind of manipulation, but directors often have a concurrent ability to amend the bylaws as well.[61]

Fortunately, the federal proxy rules do not prevent shareholders from voting "no" on fundamental transactions.[62] However, they do limit shareholders' ability to communicate with each other and coordinate their response to any proxy solicitation.[63] Thus, they limit

[59] *See, e.g.*, Paramount Comm., Inc. v. Time Inc., 571 A.2d 1140, 1145-48 (Del. 1989) (stating that directors restructured transaction from merger to purchase to avoid shareholder vote). There is a requirement of shareholder approval on the part of the company selling "all or substantially all" of its assets. *See* DEL. CODE ANN. tit. 8, § 271(a); MODEL BUS. CORP. ACT § 12.02(a). However, a merger requires the approval of the shareholders of *both* corporations.

[60] The terms of a merger agreement can include amendments to the charter. *See* DEL. CODE ANN. tit. 8, § 251(b); MODEL BUS. CORP. ACT § 11.02(c)(4).

[61] *See* DEL. CODE ANN. tit. 8, § 109(a) (charter may confer power to amend bylaws on directors); MODEL BUS. CORP. ACT § 10.20(b) (charter may deny directors power to amend bylaws).

[62] *See* 17 C.F.R. § 240.14a-4(b)(1) (2006).

[63] The proxy rules arguably did more to exclude insurgents than they did to empower shareholders. *See* Black, *supra* note 44, at 536-42; Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 823-24 (1992) [hereinafter Black, *Agents*]. If anyone would like to run a proxy contest in order to replace the incumbent board, she would be subject to the strict disclosure requirements of the proxy rules. *See* Securities Exchange Act, Regulation 14A, 17 C.F.R. §§ 240.14a-1 to -15, -101 (2005). The expense is likely to discourage many who otherwise might consider the possibility. In fact, the overly strict requirements not only discourage potential proxy contestants, but also may prevent shareholders from acting together in order to influence elections. For example, the proxy rules define "solicitation" to include "any request for a proxy," "any request to execute or not to execute, or to revoke, a proxy," and any "communication . . . under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." *Id.* § 240.14a-1(*l*)(1). Arguably, this definition is broad

shareholders' ability to exercise their control rights effectively.

There is one way in which the federal proxy rules advance shareholder access to the proxy mechanism: under Securities and Exchange Commission Rule 14a-8, shareholders may propose initiatives for shareholder vote, which the corporation must include on its proxy under certain conditions.[64] Although the conditions are numerous and fairly strict, shareholders often are able to include non-binding proposals for director consideration.[65] Thus, the proxy rules enable shareholders to "send a message" to the directors. Directors increasingly are taking shareholder proposals seriously.[66] Thus, shareholder access to management's proxy materials has the potential to enhance the shareholder's role in corporate governance.

3. Information Rights

Shareholders also have the right to at least some information about the corporation's affairs. Under state law, this right is not very broad. In many states, including Delaware, shareholders have no general right to information — only certain specific rights.[67] For example, shareholders generally do have the right to inspect the corporation's books and records.[68] However, this right is not as impressive as it may sound. Shareholders bear a "not insubstantial" burden of demonstrating a proper purpose.[69] In addition, they are entitled to review only basic documents, such as the charter, bylaws, minutes of

enough to include even casual conversations among shareholders! *See* Regulation of Communications Among Shareholders, Release No. 34-31326, 57 Fed. Reg. 48,276, 48,277-78 (Oct. 22, 1992) (to be codified at 17 C.F.R. pts. 240, 249). Fortunately, the SEC has been easing the restrictions on shareholder communications for some time. *See, e.g.*, 17 C.F.R. §§ 240.14a-2(b), 240.14a-1(*l*)(2)(iv), 240.14a-12; *see also supra* note 48 (discussing costs involved in proxy contests). These reforms have improved shareholders' ability to exercise their right to vote in a meaningful manner, but formidable obstacles to shareholder cooperation remain.

[64] *See* 17 C.F.R. § 240.14a-8.

[65] *See id.* § 240.14a-8(i)(1) note.

[66] *See* Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 68-74 (2004).

[67] Some states require corporations to provide shareholders with annual financial statements. *See* MODEL BUS. CORP. ACT § 16.20 (2004).

[68] *See, e.g.*, DEL. CODE ANN. tit. 8, § 220 (2006); MODEL BUS. CORP. ACT §§ 16.02-16.03.

[69] *See* Security First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 568 (Del. 1997).

board meetings, and the list of shareholders of record.[70] Shareholders must establish the legitimacy of their request for additional information.[71]

Generally, state law does provide that the board of directors must affirmatively disclose information when seeking action on the part of the shareholders.[72] This duty has been said to "require[ ] 'complete candor' in disclosing fully 'all of the facts and circumstances . . . ,'"[73] and without such information the shareholder approval is invalid.[74] However, this duty of candor is enforced through the filter of materiality: there is a breach of duty only if the omission or inaccuracy is deemed material.[75] Thus, strict candor is not required.

In truth, shareholders of public corporations get the bulk of their right to information from the federal securities laws. In particular, the Securities Act of 1933[76] and the Securities Exchange Act of 1934[77] create an elaborate framework of ongoing mandatory disclosures about virtually every aspect of the company's business.[78] Armed with this information, shareholders are empowered to protect their economic and control interests. However, the federal securities laws apply only to public corporations. Shareholders of small, closely held corporations are relegated to the state disclosure laws.

4. Litigation Rights

Shareholders also have the ability to seek judicial enforcement of their other rights under certain circumstances. Most significantly, they have the right to seek enforcement of, and redress for breach of, management's fiduciary duties to "the corporation and its shareholders" by means of derivative litigation.[79] This is especially

[70] *See, e.g.*, MODEL BUS. CORP. ACT §§ 16.01, 16.02(a)-(b).

[71] *See Security First Corp.*, 687 A.2d at 569.

[72] *See* Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998).

[73] Lynch v. Vickers Energy Corp., 383 A.2d 278, 279 (Del. 1978) (citations omitted).

[74] *See* Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1107-08 (1991).

[75] Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) ("[I]t is more appropriate . . . to speak of a duty of disclosure based on a materiality standard rather than . . . a 'duty of candor.'").

[76] 15 U.S.C. §§ 77a-77aa (2006).

[77] 15 U.S.C. §§ 78a-78mm (2006).

[78] *See, e.g.*, Securities Exchange Act § 13(a)-(b), 15 U.S.C. § 78m(a)-(b); 17 C.F.R. §§ 240.13a-1, -11, -13 (2006) (annual reports, current reports, and quarterly reports, respectively).

[79] The courts are not very precise when describing to whom directors owe

noteworthy because, technically speaking, derivative actions are brought on behalf of the corporation, and it is the directors who are entitled to decide whether or not to pursue legal action.[80] When directors are conflicted, however, shareholders are permitted to take legal action on behalf of the corporation.[81] This permits them to enforce the duties of which they are the indirect beneficiaries.

Unfortunately for shareholders, the conditions under which they are permitted to maintain derivative actions are severely limited, as are the chances for success on the merits. In the first place, the law imposes a number of procedural obstacles to the initiation and maintenance of a derivative lawsuit. For example, the contemporaneous ownership rule denies standing to anyone that was not a shareholder at the time of the action complained of;[82] the demand requirement insists that directors be given the opportunity, in most cases, to decide whether a lawsuit is appropriate.[83] Even after an action has been initiated properly, a special litigation committee of the board of directors may be able to have it dismissed.[84] Obstacles such as these are not necessarily unjust: the ability of shareholders to pursue derivative actions is an exception to the general rule that directors should manage the corporation, and it seems reasonable to have protections against various forms of abuse.[85] However, such procedures clearly limit shareholders' ability to pursue derivative actions.

In addition, the substantive standards under which directors' actions are judged in derivative litigation are quite lenient. One of the most basic principles of corporate law is that the business judgment rule

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fiduciary duties:

> [T]he equivalence of "corporation" and "shareholders" . . . is most clearly seen in the manner in which courts and writers have used these terms, and that usage tends to show that they use them as equivalents. In *Unocal*, the Delaware Supreme Court, in the course of two pages, described the directors' "fundamental duty and obligation" as running first to "the corporate enterprise, which includes stockholders," later to "the corporation and its shareholders," and finally, to just "the corporation's stockholders."

A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 48-49 (1991) (citations omitted).

[80] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785-86 (Del. 1981).

[81] *See, e.g.*, *id.* at 784 (quoting McKee v. Rogers, 156 A. 191, 193 (Del. Ch. 1931)).

[82] *See, e.g.*, DEL. CODE ANN. tit. 8, § 327 (2001).

[83] *See, e.g.*, DEL. CH. CT. R. 23.1.

[84] *See, e.g.*, *Zapata*, 430 A.2d at 779; Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979).

[85] *See Zapata*, 430 A.2d at 786-87.

provides directors with tremendous deference and great protection against liability.[86] Thus, even if shareholder plaintiffs overcome the obstacles to derivative litigation, they face considerable difficulty on the merits.

The challenges that apply to derivative actions are not applicable when shareholders sue to enforce their own legal rights. Nevertheless, shareholders' right to legal action is not much more significant in the context of direct actions.

The circumstances under which shareholders may bring actions in their own name are limited. For example, they may sue for the non-payment of dividends. However, this is true only if they have a legal right to dividends (i.e., after dividends have been declared by the board of directors). Shareholders also have the right to petition the court for dissolution of the corporation under certain circumstances. Although state laws vary, the standards typically require egregious behavior or other extreme circumstances,[87] and courts generally are hesitant to order dissolution.[88]

If a corporation engages in certain fundamental transactions, such as a merger, its shareholders often have appraisal rights: they can forgo the contractual consideration due under the merger agreement and petition a court for the fair value of their shares.[89] Again, state laws vary, but appraisal rights are always limited and often expensive. In Delaware, for example, appraisal rights apply only in the context of mergers — and even then with certain exceptions.[90] In addition, the shareholders seeking an appraisal often must pay the costs of providing the remedy,[91] making it attractive only in the most extreme cases.

Although shareholders' right to take legal action under state corporate law is rather limited, their rights under federal securities law are significantly more robust. Shareholders generally do have the right to sue directly and to initiate class actions. Not only does federal law

[86] *See infra* notes 115-19 and accompanying text.

[87] *See, e.g.*, N.Y. BUS. CORP. LAW § 1104-a(a) (Consol. 2006); MODEL BUS. CORP. ACT § 14.30(2) (2004).

[88] *See* FRANKLIN A. GEVURTZ, CORPORATION LAW § 5.1.2, at 463 (2000).

[89] *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(e) (2006).

[90] *See id.* § 262(b).

[91] *See id.* § 262(j). *But see* MODEL BUS. CORP. ACT § 13.31 (cost paid by corporation).

provide shareholders with various explicit causes of action,[92] but the courts have supplemented them with implied causes of action.[93]

However, federal securities laws only go so far. They generally cover only the right to information. Shareholders have broad protection against deception, but very little protection against substantive misconduct, such as breach of fiduciary duty or unfairness.[94] Moreover, the trend in federal securities law is to limit, rather than expand, shareholders' right to sue.[95] Thus, litigation rights under the federal securities laws are also subject to significant limitations.

B. Prioritizing the Rights

In this section, I argue that, of all the rights discussed above, two stand out above the rest. These are the right to elect directors and the right to sell shares. Other rights are less fundamental because they are either ancillary or illusory.

With respect to the economic rights, dividends are simply far less significant than the right to sell shares. Because the decision to pay dividends is within the discretion of the board of directors, the legal "right" to dividends is illusory. As previously discussed, shareholders often do not expect much in the way of dividends. In fact, shareholders historically have had reason to prefer not to receive dividends: dividends have received unfavorable tax treatment relative to other means of extracting economic benefits from the corporation.[96]

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[92] *See, e.g.*, Securities Act §§ 11-12, 15 U.S.C. §§ 77k, 77*l* (2006); Securities Exchange Act §§ 18, 20A, 15 U.S.C. §§ 78r, 78t-1 (2006).

[93] *See, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (affirming existence of implied cause of action under Exchange Act § 10(b) and SEC Rule 10b-5).

[94] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474-76 (1977).

[95] *See supra* note 6 and accompanying text.

[96] The Internal Revenue Code recently was amended to improve the tax treatment of dividends by subjecting them to capital gains rates, which are lower than ordinary rates. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301-302, 117 Stat. 752, 758-64 (2003). Prior to the amendment, it generally was preferable for shareholders to extract economic benefits from the corporation by means of capital gains rather than through dividends. It should be noted that this amendment will expire, and rates will return to "normal," after December 31, 2010. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, 346 (2006).

With respect to closely held corporations, dividends also have suffered a disadvantage by comparison to compensation because salary expenses are deductible to the corporation while dividend payments are not. *See* I.R.C. § 162(a) (2000).

By contrast, the right to sell shares is quite robust. There are some significant limits relating chiefly to change in control situations. For the most part, however, shareholders have a strong right to sell shares and to any resulting profit. This right of alienation is of the utmost importance to shareholders both because it is a means of obtaining economic benefit from their investment in the corporation[97] and because it is their means of exit should they become dissatisfied with management.[98] Indeed, at least ostensibly, any restrictions on the right to sell shares are intended to protect shareholders.

With respect to control rights, the right to elect directors is more important than other rights, such as the right to approve fundamental transactions. This is because the line between fundamental transactions that require shareholder approval and other transactions that do not is inherently unstable. Directors often are able to restructure the former into the latter so that no shareholder approval is necessary. This makes the right largely, albeit not entirely, illusory. The right to vote on shareholder proposals also is largely illusory because shareholder proposals generally are not binding on directors. Perhaps the right to amend the bylaws is more substantial, but it is shared with directors. Arguably, directors could repeal any shareholder-adopted bylaw,[99] or at least amend the bylaws so as to interfere with a shareholder-adopted bylaw.

It may be argued that the right to elect directors is not very important to shareholders. After all, shareholders are rationally apathetic and are not particularly interested in voting. However true that may be of individual shareholders, it would be unfair to say that all shareholders are rationally apathetic. With the rise of large institutional shareholders holding much larger interests in corporations, it may be quite rational for some shareholders to

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However, this issue is complicated by payroll taxes, and the disadvantage is somewhat muted by the lower personal income tax rate on dividends.

[97] *See supra* notes 25-28 and accompanying text.

[98] Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 406 (1994) ("The Wall Street Rule holds that shareholders who are dissatisfied with management decisions can 'vote with their feet' by selling their shares and finding a different enterprise in which to invest."); *see* J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER 60-67 (1958); Frank D. Emerson, *Some Sociological and Legal Aspects of Institutional and Individual Participation Under the SEC's Shareholder Proposal Rule*, 34 U. DET. L.J. 528, 534 (1957).

[99] *Compare* DEL. CODE ANN. tit. 8, § 109(a) (2006) (directors may be permitted to amend bylaws), *with id.* § 216 (directors cannot amend shareholder-adopted bylaws relating to voting standards in director elections).

monitor corporate affairs much more closely.[100] In fact, there have been signs of increased institutional activism for some time now.[101] And one could fairly question the extent to which any existing apathy is the product of economic disincentives, as opposed to legal disincentives, provided by laws that place obstacles in the path of shareholder activism.[102] In other words, shareholder apathy is not necessarily an inescapable state of affairs.

Moreover, even if shareholder voting rights are not, and cannot be, effective in ensuring shareholder monitoring under ordinary circumstances, they can still be an important aspect of corporate governance by providing an avenue for shareholder activism in extraordinary circumstances. Thus, even if a board of directors ordinarily will be self-perpetuating, the right to elect directors allows for a proxy contest by a significant minority shareholder or a would-be acquirer — and this possibility may keep directors accountable. By contrast, without the right to elect directors, the board could not be removed even by shareholders acting unanimously.[103] In short, the election of directors is a right that shareholders as a group cannot do without, even if individually they are not particularly enthusiastic about it. Thus, the right is neither unimportant nor illusory; it is merely under-appreciated and under-protected.

While information rights are important, they are ancillary or merely supportive of the shareholder's economic and control rights. Information is not a good in and of itself; rather, it is instrumental. It allows shareholders to decide whether to invest or disinvest in a company, as well as to decide whether to approve a given candidate or transaction. To be sure, the shareholder's economic and control rights would be significantly less valuable without information; however, the information rights would be meaningless without some ability to act.

Likewise, the right to sue cannot be considered as important as either the right to elect directors or the right to sell shares. Not only is the right rather limited, but it seems that any change in the near future is more likely to be restrictive than expansive. More importantly, the right to sue is ancillary to the economic and control rights of the

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[100] *See generally* Black, *Agents*, *supra* note 63 (describing oversight by institutional investors).

[101] *See id.* at 827-29; Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 278-80 (2000).

[102] *See generally* Black, *supra* note 44 (describing legal obstacles faced by shareholders).

[103] *See infra* notes 238-39 and accompanying text.

shareholder. The right to sue is nothing more than the ability to enforce other legal rights.

In short, the right to elect directors and the right to sell shares are the two most important rights held by shareholders. Other rights also may be important and valuable. However, these two are, by their very nature, fundamental rights.

II. FORMALISM IN CORPORATE LAW

In this part, I consider the fundamental rights of the shareholder in the context of the general nature of corporate law. I argue that, unlike many other areas of law, corporate law is characterized by a high degree of formalism. This formalism tends to favor directors by affording them a great deal of discretion: they may take almost any action, provided that they follow the appropriate rules. However, it also provides a natural limit to the role of directors: they are authorized to manage the affairs of the business, but not to manage the affairs of the shareholders. I argue that, because decisions regarding the election of directors and the sale of shares are the affairs of the shareholders rather than the corporation, formalism should lead to a healthy respect for the fundamental rights of the shareholder.

I begin in section A by examining the nature of formalism in corporate law. I argue that this formalism is pervasive enough to extend beyond law and into equity. Then, in section B, I argue that corporate law's formalism strongly supports the fundamental rights of the shareholder because neither shareholders nor directors should be able to intrude upon the role of the other. I also criticize the fact that, while courts have recognized this principle with respect to the shareholder's right to vote, they have not extended this principle to the right to sell shares. Next, in section C, I argue that the courts' failure to do so represents a serious problem from the perspective of formalism. Finally, in section D, I lament the fact that the courts are unwilling to stand firmly behind the principles that led them to protect the right to vote, and I argue that the result is inadequate protection for the fundamental rights of the shareholder.

A. Corporate Law's Formalism

One of the chief characteristics of corporate law is its formalism. As any first year law student is supposed to know, substance is supposed to prevail over form under the law. While this may be true in many areas of law, it is not true for corporate law — at least not at the state

law level.[104] Corporate law exhibits a strong preference for form and process over the underlying substance of a transaction or the merits of a claim.[105] A full defense of this assertion would be beyond the scope of this article, but it should not be controversial to anyone familiar with corporate law. Two examples should suffice to demonstrate both the nature and extent of this formalism.

The first example is the equal dignity rule, also known as the doctrine of independent legal significance. According to this doctrine, the various statutory provisions of corporate law are of independent legal significance, and actions taken under one section are not judged by reference to the provisions of another.[106] The quintessential manifestation of this rule was the demise of the de facto merger doctrine. Under the de facto merger doctrine, a transaction that technically was not structured as a merger but that had the same effect as one would be treated as a merger by the courts.[107] The purpose of the doctrine was to ensure that the substance of a transaction prevailed over its form, and that companies would not be able to avoid the statutory requirements for mergers merely by calling them something else.[108] The de facto merger doctrine is utterly inconsistent

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[104] *See* Uni-Marts, Inc. v. Stein, CIV.A. Nos. 14893, 14713, 1996 WL 466961 (Del. Ch. Aug. 12, 1996).

> [W]hen construing the reach and meaning of provisions of the Delaware General Corporation Law, our law is formal. Formality in the analysis of intellectual problems has been largely out of fashion for much of this century, and Delaware corporation law has sometimes been criticized for its reliance on formality. But the entire field of corporation law has largely to do with formality. Corporations come into existence and are accorded their characteristics, including most importantly limited liability, because of formal acts. Formality has significant utility for business planners and investors. . . . [T]he utility offered by formality in the analysis of our statutes has been a central feature of Delaware corporation law.

Id. at *9. Federal securities law is far less formalistic.

[105] The term "formalism" has many possible meanings. *See generally* Richard H. Pildes, *Forms of Formalism*, 66 U. CHI. L. REV. 607 (1999) (describing various meanings). This article will use the term as described in the text. It is intended to convey more than merely strict interpretation of statutory language, but also to encompass a general hesitancy to accept responsibility for making a substantive assessment.

[106] *See* Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963).

[107] *See, e.g.*, Farris v. Glen Alden Corp., 143 A.2d 25, 30-31 (Pa. 1958).

[108] In restructuring transactions to avoid mergers, companies often seek to avoid the requirements of shareholder votes or appraisal remedies, or both. *See supra* note 56; *see also* DEL. CODE ANN. tit. 8, § 262 (2006); MODEL BUS. CORP. ACT § 13.02 (2004).

with the equal dignity rule, which insists that the statutory requirements for a merger apply only to mergers and not to other legal transactions, such as asset purchases. With the adoption of the equal dignity rule, the de facto merger doctrine was abolished.[109]

The robustness of the equal dignity rule cannot be overstated. Lawyers have learned to manipulate corporate law to an incredible degree. For example, they have learned that, by restructuring a merger into a two-step transaction consisting of a triangular merger[110] followed by a short-form merger,[111] they can achieve the *exact* same result as a standard merger, but without the requirement of a shareholder approval for one of the two corporations.[112] Such hyper-technicality represents the pinnacle of formalism and would have been inconceivable under the de facto merger doctrine. However, the courts have upheld such machinations under the equal dignity rule and now they are common practice.

The extent of formalism in corporate law can be illustrated further by reference to a second example, the law of fiduciary duties. Whereas the technical requirements for a merger or other types of transactions are purely a matter of positive statutory law, fiduciary duties are the product of equity. Whatever justifications may exist for formalism with respect to the former have much less weight with respect to the latter.[113] And yet, a careful examination reveals that the corporate law of fiduciary duties is replete with formalism.

If courts were concerned with substance rather than form, they would seek to reach the merits of claims of breach of fiduciary duty; instead, they focus on process to avoid the merits. As previously discussed, the law makes it difficult to initiate and maintain an action

[109] Although the de facto merger doctrine has been abolished with respect to claims made by shareholders, it still has some vitality with respect to claims made by creditors. *See, e.g.*, Ruiz v. Blentech Corp., 89 F.3d 320, 325 (7th Cir. 1996) (discussing successor liability).

[110] *See* BAINBRIDGE, *supra* note 35, § 4.4, at 161-62.

[111] *See, e.g.*, DEL. CODE ANN. tit. 8, § 253; MODEL BUS. CORP. ACT § 11.05 & cmt.

[112] The first transaction avoids a shareholder vote because the merger is between one corporation and the subsidiary of another: the shareholder approval requirement is satisfied because the shareholder of the subsidiary is the parent corporation, not the parent corporation's shareholders. The second transaction avoids a shareholder vote because a short-form merger provides an explicit statutory exception to the requirement of shareholder approval.

[113] *See* Speiser v. Baker, 525 A.2d 1001, 1011 (Del. 1987) ("[O]ur law is the polar opposite of technical and literal when the fiduciary duties of corporate officers and directors are involved."); Uni-Marts, Inc. v. Stein, CIV.A. Nos. 14893, 14713, 1996 WL 466961, at *9 (Del. Ch. Aug. 12, 1996) ("[T]he essential fiduciary analysis component of corporation law is not formal but substantive . . . .").

for breach of fiduciary duty by placing various obstacles in the way of the shareholder plaintiff.[114] Things do not get better once those obstacles have been cleared. The shareholder is then confronted with the business judgment rule.[115] The business judgment rule creates a strong presumption that the board has acted properly[116] and provides directors with great protection against liability.[117] The substance of a business decision is essentially beyond challenge.[118] Allegations of a breach of the duty of care are difficult to substantiate because they are adjudicated under a gross negligence standard.[119] While allegations of a breach of the duty of loyalty are adjudicated under a more demanding "entire fairness" standard,[120] this is true only if they rise to the level of self-dealing.[121] Even so, directors' actions will be upheld as long as they were "fair."[122] In fact, the defendants often can escape even fairness review simply by shifting the decision to formally disinterested directors.[123]

Although each of these rules may be justifiable, they clearly are not intended to ensure the correct substantive determination of whether the directors have breached their fiduciary duties to the shareholders. Even in these issues of equity, corporate law focuses on process and procedure rather than substance and the merits. Thus, it would be difficult to deny that state corporate law is characterized by a very high degree of formalism.

B. The Roles of the Director and the Shareholder

As previously mentioned, corporate law does a better job at defining the role of directors than it does defining the role of shareholders.

[114] *See supra* notes 82-85 and accompanying text.

[115] *See generally* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 828-34 (2004) (describing business judgment rule).

[116] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[117] *See* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

[118] *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

[119] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985); *Aronson*, 473 A.2d at 812.

[120] *See generally* Velasco, *supra* note 115, at 834-38 (describing entire fairness standard).

[121] *See id.* at 853-54.

[122] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) (citing Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983)) ("A finding of perfection is not a *sine qua non* in an entire fairness analysis.").

[123] *See* DEL. CODE ANN. tit. 8, § 144(a) (2006); MODEL BUS. CORP. ACT § 8.62 (2004).

Directors clearly are the ultimate managers of the business. Shareholder voice is limited to a few instances explicitly authorized by statute. The business judgment rule reflects this broad delegation of authority to directors by respecting their discretion.

As broad as director authority is, however, it is not unlimited. Directors have authority to manage the affairs of the business, but not to manage the affairs of the shareholders; similarly, they have power to control the assets of the business, but not to control the personal assets of the shareholders.[124] Just as director authority is protected by the business judgment rule, so too should shareholder rights be protected. Likewise, just as shareholder intervention in corporate affairs is not permitted unless statutorily authorized, neither should director intervention in shareholder affairs be permitted unless absolutely necessary. Thus, because the rights to elect directors and to sell shares belong to shareholders alone, director interference with those rights should be highly suspect.

The courts have recognized this principle, at least with respect to the right to vote. In a line of cases stretching back over three decades[125] and culminating in the case of *Blasius Industries, Inc. v. Atlas Corp.*,[126] the Delaware courts have shown a willingness to prevent directors from intentionally interfering with shareholder democracy. Although *Blasius* was decided by the Delaware Court of Chancery, its holding and rationale have been accepted and reaffirmed by the Delaware Supreme Court.[127] *Blasius* thus stands as the leading case on directors' fiduciary duties with respect to shareholder voting rights.

In that case, Blasius, a nine percent shareholder of Atlas, sought to expand the board of directors of the company from seven to fifteen members and to name eight new directors, all by consent solicitation. In response, the directors quickly expanded the size of the board to nine members and appointed two new directors. This was done in order to prevent Blasius from naming a majority of directors.[128] The court believed that the directors were acting in good faith in order to protect the remaining shareholders.[129] However, the court held that whenever directors act for the primary purpose of thwarting a

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[124] *See* DEL. CODE ANN. tit. 8, § 141(a); MODEL BUS. CORP. ACT § 8.01.

[125] *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

[126] 564 A.2d 651 (Del. Ch. 1988).

[127] *See, e.g.*, MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1129-32 (Del. 2003); Stroud v. Grace, 606 A.2d 75, 79, 91 (Del. 1992). *But see infra* note 160 and accompanying text.

[128] *Blasius*, 564 A.2d at 654-56.

[129] *Id.* at 658.

shareholder vote, their actions cannot be upheld without a compelling justification.[130] In that case, there was none.[131]

The reasoning behind the decision in *Blasius* was precisely that the right to elect directors is a shareholder matter rather than a business matter:

> [T]he ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. . . . A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of the corporation's power over its property, or with respect to its rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation.[132]

Of course, because the procedural details of shareholder voting must be attended to, directors are required to play a role in the voting process. However, they are not permitted to abuse that role by interfering with the fundamental rights of the shareholder.

Unfortunately, the Delaware courts have limited *Blasius* to the right to vote. According to them, special treatment is appropriate because "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[133] However, the logic of *Blasius* applies equally well, or better, to the right of the shareholder to sell her shares.[134] A shareholder's investments are the affairs of the shareholder, not of the corporation; shares of the corporation are the assets of the shareholder, not of the corporation. The decision of whether or not to buy or sell shares belongs to the shareholder, and the directors have no right to interfere.

[130] *Id.* at 661-62.

[131] *Id.* at 662-63.

[132] *Id.* at 659-60 (emphasis and footnotes omitted).

[133] *Id.* at 659; *see also id.* at 660 ("Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority.").

[134] *See* Velasco, *supra* note 115, at 891-92.

Rather than apply the logic of *Blasius* to the shareholder's right to sell shares, the courts have allowed significant interference with that right in cases involving hostile takeovers.[135] The initial justification for permitting these incursions on shareholder rights was that they were necessary to protect shareholders from collective action problems in the face of coercive offers.[136] This can no longer serve as the primary rationale, however, both because of the demise of coercive offers and because of the increased discretion directors have been given to "just say no"[137] to hostile bidders.[138]

The current defense of director interference is based on the rationale behind the business judgment rule — that courts should not be substituting their judgment for the directors' on the issue of whether or not the transaction is beneficial to shareholders.[139] This argument fails. Elsewhere, I have argued at length that the issue of structural bias makes deference to directors wholly inappropriate.[140] In addition, the logic of *Blasius* demonstrates that the rationale behind the business judgment rule simply does not apply in situations involving the fundamental rights of the shareholder:

> The only justification that can, in such a situation, be offered . . . is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant (except insofar as the shareholders wish to be guided by the board's recommendation) when the question is who should comprise the board of directors. The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.[141]

This is as true with respect to the right to sell shares as it is with respect to the right to elect directors. If the question is who should have the right to decide whether shareholders should be entitled to

[135] *See supra* notes 34-38 and accompanying text.

[136] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949, 956 (Del. 1985).

[137] Thompson & Smith, *supra* note 12, at 315 ("'Just say no' is a label used to describe a context in which a board of directors attempts to stonewall a hostile takeover bid indefinitely.").

[138] *See* Velasco, *supra* note 37, at 412-16.

[139] *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) (quoting Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)); *Unocal*, 493 A.2d at 949.

[140] *See generally* Velasco, *supra* note 115.

[141] Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988).

sell shares, the answer must be the shareholders themselves and not the directors.

As previously noted, directors cannot block shareholders from selling their shares on the open market; they can only block a tender offer.[142] However, tender offers are a critically important avenue for the sale of shares because they implicate both of the fundamental rights of the shareholder. Obviously, economic rights are at stake because the hostile bidder generally offers a significant premium to the market price of the shares. However, control rights also are at stake because the hostile bidder often seeks to replace the existing directors.[143] Thus, in a very real sense, the right of the shareholder to sell shares in the context of a hostile takeover involves the same issues of legitimacy that were the *Blasius* court's concern. In short, *Blasius* cannot be limited to the right to vote.

C. Revival of the De Facto Merger Doctrine

As previously discussed, the courts allow the board of directors to interfere with the shareholder's right to sell shares in a hostile tender offer.[144] This is so even though a tender offer is a transaction between the shareholders and the hostile bidder, and technically does not involve the corporation.[145] What has escaped attention thus far, however, is that this amounts to a revival of the de facto merger doctrine: the courts are allowing the imposition of one of the requirements of mergers (i.e., director approval) onto a form of transaction that does not call for it.

As a policy matter, it would not be irrational to give directors a veto over tender offers. Although, in theory, a tender offer may not involve the corporation, in fact, it is of tremendous importance to the corporation. As a general matter, shareholders do not have the right to make important corporate decisions by themselves: fundamental transactions such as mergers and charter amendments first must be vetted by the directors.[146] Thus, a tender offer, which involves the same types of issues as a merger, arguably *should* be considered by directors first.[147] But the equal dignity rule forbids such arguments. There is no "general matter" in corporate law. Mergers require

[142] *See supra* note 38 and accompanying text.

[143] *See infra* notes 232-39 and accompanying text.

[144] *See supra* notes 34-38 and accompanying text.

[145] *See supra* note 35 and accompanying text.

[146] *See supra* notes 56-57 and accompanying text.

[147] For the record, I disagree.

director input, but tender offers do not — just as mergers require shareholder input, but asset purchases do not. Tender offers are transactions of independent legal significance and should not be judged by reference to mergers. By allowing directors the same voice in tender offers that they have in mergers, the courts are treating tender offers as de facto mergers.

It bears emphasis that these developments did not signal a wholesale revival of the de facto merger doctrine. Shareholders have not been given the right to vote in asset purchases or triangular mergers, and there is no indication that they will be. In such cases, the equal dignity rule is alive and well, and the de facto merger doctrine is as defunct as ever. Rather, the de facto merger doctrine has been revived selectively for the benefit of directors and to the detriment of shareholders. This inconsistency is incompatible with corporate law's formalism.

D. The Fate of Blasius

In the 1980s, Delaware law began to exhibit a preference for the shareholder right to vote over the right to sell.[148] While the courts permitted directors to implement takeover defenses that would block hostile tender offers,[149] they simultaneously announced an enhanced protection for shareholder democracy.[150] In fact, the courts emphasized the importance of shareholder democracy and declared it the basis of legitimacy for director authority.[151]

Professor Ronald Gilson has argued that the courts' tradeoff was not a reasonable one because markets are more efficient than elections at mediating the transfer of control.[152] His argument makes sense on a policy level. However, a judicial preference either way should not make any difference. Shareholders are entitled to the protection of both fundamental rights, not just one.

In fact, if the two rights were to be ranked, shareholders would be far more interested in the right to sell shares than the right to elect directors. In addition to the underlying economic realities leading to

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[148] *See* Ronald J. Gilson, Unocal *Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 500-01 (2001).

[149] *See supra* notes 34-37 and accompanying text.

[150] *See supra* notes 126-32 and accompanying text.

[151] *See supra* note 133 and accompanying text.

[152] *See* Gilson, *supra* note 148, at 502-05; *cf.* Chesapeake Corp. v. Shore, 771 A.2d 293, 326 (Del. Ch. 2000) (arguing inconsistency of allowing shareholders to act by voting but not by selling).

rational apathy, federal proxy rules have emasculated shareholder democracy further.[153] The Delaware courts were not unaware of this. They knew that they were emphasizing shareholder voting rights even though the conventional wisdom long had held that they were virtually meaningless.[154]

As time passed, court decisions solidified around the directors' right to implement takeover defenses, and these defenses became increasingly sophisticated and powerful. The hostile takeover had become much less of a threat. Taking a cue from court opinions, however, would-be acquirers began to couple their hostile tender offers with proxy contests intended to replace entrenched directors with new directors that would be favorably inclined towards a takeover offer.[155] Shareholders could and did respond by exercising their right to vote so as to protect their right to sell shares. Hostile takeovers could proceed after a successful proxy contest.[156] And, if *Blasius* were to be believed, directors would not be permitted to interfere with the proxy contest.[157]

The significance of the proxy contest increased with the rise of the institutional investor.[158] Rational apathy on the part of the shareholders stems from dispersed ownership; with large institutional investors holding significant minority interests in many corporations, the old paradigm was becoming inapplicable. If shareholders are not individuals with meager holdings, but rather large institutions with sizeable holdings, then rational apathy might no longer apply.[159] Although other obstacles to shareholder activism remained, the right to vote was becoming increasingly significant.

Unfortunately, the courts were unwilling to maintain their emphasis on the fundamental importance of shareholder voting rights. Once the authority of directors to resist hostile takeovers was firmly established, the courts began to pull back on *Blasius*. By 1996, the Delaware Supreme Court stated explicitly that "*Blasius'* burden of demonstrating a 'compelling justification' is quite onerous, and . . . therefore [should be] applied rarely."[160] Such reluctance to apply the doctrine can only

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[153] *See supra* notes 42-51 and accompanying text.

[154] *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

[155] *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985) (suggesting strategies to defeat poison pill).

[156] *See* Velasco, *supra* note 37, at 383-84.

[157] *See supra* note 130 and accompanying text.

[158] The *Blasius* court noticed this development. *See Blasius*, 564 A.2d at 659.

[159] *See supra* notes 100-01 and accompanying text.

[160] Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996); *see also* MM Cos. v. Liquid

ensure that *Blasius* will not have nearly the impact that it should. As a result, neither the right to elect directors nor the right to sell shares will be accorded adequate protection, even though general principles of corporate law suggest that they must.

III. THE TRADITIONAL VIEW

In the next three Parts of this Article, I consider the fundamental rights of the shareholder from the perspective of the three major competing theories of the corporation. In this Part, I focus on the traditional view of the corporation, which recognizes the shareholders as the owners of the corporation. The traditional view naturally provides strong theoretical support for shareholders' rights. However, corporate law never has given shareholders the degree of power that might be expected of an owner. Therefore, I focus on reconciling the traditional view with the limited role of the shareholder in corporate governance. The solution can be found in fiduciary duties that directors owe to shareholders.

In section A, I briefly set forth the traditional view and defend the role of the director in corporate governance as beneficial for the shareholder. Then, in section B, I demonstrate the importance under the traditional view of the rights to elect directors and to sell shares. I argue that limits on shareholder control of the business can be perfectly consistent with their interests as long as the limits do not empower directors to interfere with the role of the shareholder.

A. The Traditional View

According to the traditional view, the corporation is a separate entity, with an identity distinct from its owners or managers. Shareholders are the owners of the corporation. They elect directors to manage the business on their behalf.[161] The purpose of the corporation is to make profits for its shareholders, and the goal of directors in managing the business must be shareholder wealth maximization.[162]

Audio, Inc., 813 A.2d 1118, 1130 (Del. 2003).

[161] Of course, the directors appoint officers to run the business on a day-to-day basis. *See supra* note 9.

[162] *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1145 (1932); Milton Friedman, *A Friedman Doctrine — The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sep. 13, 1970, at SM17.

Although the traditional view recognizes the shareholders as the owners of the corporation,[163] the law long has provided that every corporation must act through a board of directors rather than its shareholders.[164] This rule is not truly a divestiture of power from the shareholders, however, because shareholders get to elect the directors. Thus, directors are accountable to shareholders (at least theoretically).

Because shareholders are owners who elect directors to run the business for them, it often is said that directors are the agents of the shareholders.[165] Actually, however, directors are not mere agents.[166] Legal agency requires not only action on behalf of another, but also control of the agent by the principal.[167] In the case of corporations, this would mean control of the directors by the shareholders. Shareholders do have some control in their ability to elect directors. However, as previously discussed, shareholders in a large public corporation may have very little actual control over the directors.[168] Moreover, even in closely held corporations, shareholders do not have direct control over directors: directors are required to exercise their own business judgment rather than follow the shareholders' instructions.[169] Director authority is said to be "original and undelegated."[170] Thus, directors may be described essentially as trustees rather than agents.[171] Like trustees, directors use their own

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[163] In some state codes, shareholder ownership is explicit; in others, it is only implicit. *Compare* MODEL BUS. CORP. ACT § 1.40(22) (2004) (defining "shares" as "proprietary interests in a corporation"), *with* DEL. CODE ANN. tit. 8, § 151 (2006) (not defining "shares").

[164] At least, this is true as a default rule. *See* DEL. CODE ANN. tit. 8, § 141(a); MODEL BUS. CORP. ACT § 8.01(b). It is as true for the closely held corporation as it is for the public corporation, although corporations organized pursuant to special close corporation statutes can avoid this rule. *See* DEL. CODE ANN. tit. 8, § 351; MODEL STATUTORY CLOSE CORP. § 21 (Supp. 1997).

[165] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

[166] *See* Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19, 34-36 (1988).

[167] *See* RESTATEMENT (SECOND) OF AGENCY § 1(1) (1984).

[168] *See supra* notes 42-51 and accompanying text.

[169] *See* People *ex rel.* Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911); *cf.* Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (stating that directors cannot abdicate responsibility for managing business).

[170] *See* N. Assurance Co. v. Rachlin Clothes Shop, Inc., 125 A. 184, 188-89 (Del. 1924) (citing Hoyt v. Thompson's Ex'r, 19 N.Y. 207, 216 (1859)); Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).

[171] *See, e.g.*, Diamond v. Oreamuno, 287 N.Y.S.2d 300, 302 (N.Y. App. Div. 1968); Gray v. Portland Bank, 3 Mass. 364, 378-79 (1807); BERLE & MEANS, *supra* note 10, at 275.

judgment to manage the trust property (i.e., the corporation),[172] but solely for the benefit of the beneficiaries (i.e., the shareholders).[173] However, directors are not trustees, either.[174] The truth is that they are sui generis fiduciaries.[175]

Whether directors are understood as agents, as trustees, or otherwise, the fact that they control the business does not negate the fact that the shareholders are the beneficial owners. Thus, under the traditional view, directors owe fiduciary duties to the shareholders, and only to the shareholders.[176] There is no room for talk of "stakeholders" or "other constituencies."[177] All other parties — creditors, employees, communities — are, simply put, third parties. They are owed no fiduciary duties and have no legitimate role in corporate governance.[178]

Third parties are not entirely without influence over the corporation. They may negotiate the terms of their contracts, or refuse to contract with the corporation altogether; alternatively, or in addition, they may seek laws regulating the behavior of the corporation.[179] But these influences are external, rather than internal to the corporation. Within the corporation, only the interests of the shareholders matter.

B. Shareholder Rights Under the Traditional View

Under the traditional view, respect for the fundamental rights of the shareholder is a given. If shareholders are the owners of the corporation, then *of course* they are entitled to strong economic and control rights. After all, owners generally are allowed to do as they please with their property, and the corporation should be no exception. What is needed, then, is an explanation for how existing limits on shareholder rights fit within the framework of the traditional view.

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[172] *See* RESTATEMENT (SECOND) OF TRUSTS § 171 (1959) (duty not to delegate); *id.* § 174 (duty to exercise reasonable care).

[173] *See id.* § 170(1) (duty of loyalty).

[174] *See* Stegemeier v. Magness, 728 A.2d 557, 562-63 (Del. 1999); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

[175] *See* 2 MODEL BUS. CORP. ACT ANN. § 8.01, at 8-7 (3d ed. Supp. 2000).

[176] But note that courts sometimes say duties are owed "to the corporation and its shareholders." *See supra* note 79 and accompanying text.

[177] *See infra* Part V.

[178] *See* Friedman, *supra* note 162, at 126.

[179] *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1443-44 (1993).

The fact that shareholders generally are free to sell shares is not surprising given property law's strong policy against restraints on alienation.[180] However, as previously noted, the law does provide limits on the right of the shareholders to sell shares.[181] These limits require explanation. First, it would make sense to separate the limits into two categories: those that are imposed by the directors and those that are not. By and large, limits in the latter category can be reconciled with the traditional view, while those in the former category cannot.

Among the restraints on alienation that are not imposed by directors are those that come from the shareholders themselves, such as transfer restrictions included in the charter. There are also limitations provided by law, such as prohibitions against insider trading and manipulation, as well as the fiduciary duty not to sell to a known or suspected looter.[182] However, each of these examples should be understood as shareholder protections rather than limitations. They do not so much represent external constraints as the ability on the part of shareholders to protect themselves from each other. To the extent that a corporation is like a partnership, reciprocal duties among the owners makes sense.[183] Thus, this type of restraint on alienation is not particularly problematic.

On the other hand, restraints on alienation imposed by directors are problematic. Permitting directors to prevent shareholders from selling their shares represents a serious failure to respect the shareholders' ownership rights. Because what is at stake is control of the shares, rather than the assets of the corporation, there is no doctrinal justification for such a limitation.[184] Limiting directors' ability to prevent shareholders from selling their shares to tender offer situations is not particularly helpful because of the stakes involved in hostile takeovers.[185] Thus, restraints on alienation imposed by directors are incompatible with the traditional view.

The claim that shareholders should have strong voting rights is complicated only slightly by the fact that directors explicitly are given the authority to manage the business. Once the distinction is made

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[180] *See generally* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS §§ 4.1-4.5 (1983).

[181] *See supra* notes 30-38 and accompanying text.

[182] *See supra* notes 30-38 and accompanying text.

[183] *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (discussing importance of fiduciary duties among partners).

[184] *See supra* notes 132-34 and accompanying text.

[185] *See supra* note 143 and accompanying text.

between managing the business and electing the managers, however, a defense is not difficult. The traditional view does not necessarily demand for shareholders a strong right to manage the business itself as long as there is a strong right to elect directors.

It seems fair to ask why the traditional view should not demand direct shareholder control of the business. Certainly, that would be a legitimate form of corporate governance. However, there are reasons to prefer an alternative. It would be very difficult to have a large number of shareholders — or even a relatively small number of shareholders — attempting to run the business directly through democratic means. Management by rationally apathetic shareholders would be both logistically problematic and substantively unwise.[186] To deal with these practical difficulties, the law provides for the election of directors to manage the business on their behalf. However, under the traditional view, this is entirely facilitative: the goal is not to take control away from shareholders, but rather to place management responsibility in the hands of talented and dedicated individuals. In theory, shareholders remain free to elect the directors of their choice — including themselves.[187] Thus, directors essentially are proxies for the shareholders, and the separation of ownership from control is not contrary to shareholders' interests.

However, even if the model of direct shareholder control of the business is rejected in favor of a model of director control, it seems fair to ask why the traditional view should not require directors to follow any directions shareholders may choose to give. That the law does not do so may suggest a more autonomous role for the director than the traditionalist might care to admit. It is true that corporate law has settled on a system that permits, and even requires, directors to exercise their own independent judgment. However, this rule is consistent with shareholder interests. It reflects an expected benefit from having decisions made by experts with access to privileged information rather than by ordinary shareholders.[188] The benefits become clearer as the number of shareholders rises: dispersed

[186] *See* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 665-66 (1996).

[187] In closely held corporations, it is common for shareholders to elect themselves as directors. That they do not tend to do so in public corporations suggests that other arrangements are preferable.

[188] *See* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 675-77 (1995); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307-11 (1983); Winter, *supra* note 2, at 263.

shareholders simply are in no position to manage the business. Thus, directors can be seen as protecting shareholders from anarchy.

Nevertheless, the fact that the law permits directors to follow their own judgment instead of complying with shareholders' wishes does not mean that director independence is intrinsically legitimate. To the contrary, it is permitted solely for the benefit of shareholders. Fiduciary duties and shareholder approval requirements limit director autonomy, and the right to elect directors is intended to keep directors accountable to the shareholders. Under the traditional view, directors should not be allowed to disregard shareholders in the long run. But a system that limits shareholders' right to control the business directly is acceptable as long as they have adequate control over directors through the election process.

In short, limitations on the economic and control rights of the shareholder may not be required by the traditional view, but they are perfectly consistent with it. However, if shareholders are the owners of the corporation, then their fundamental rights of electing directors and selling shares must be respected. They should not be subject to director interference.

IV. THE LAW AND ECONOMICS PERSPECTIVE

In this Part, I consider the fundamental rights of the shareholder from the perspective of the second major competing theory of the corporation — that of law and economics. The law and economics theory of the corporation, also known as contractarian theory, is the prevailing view in the legal academy.[189] It views the corporation as nothing more than a web of contractual relationships. Shareholders are not owners, but merely one type of investor among many. Although it might seem that shareholder rights would not be very important under this theory, that is not the case.

In section A, I set forth the framework of contractarian theory. Then, in section B, I demonstrate how, despite downgrading the shareholder's status, the theory affirms the norm of shareholder primacy. Finally, in section C, I describe how the rights of the shareholder to elect directors and to sell shares play an important role in corporate governance. These rights protect the interests of shareholders as well as those of society generally.

[189] There is no one orthodox version of the contractarian theory. *See* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 419 (1989). Although contractarians disagree even on some fundamental issues, a fairly consistent worldview nevertheless emerges and is presented in this part.

A. The Contractarian Framework

The separate entity status of the corporation is, of course, a legal fiction.[190] The law finds the metaphor useful, because it allows the corporation to own property in its own name, to enter into contracts, and to be liable for its own obligations without reference to the shareholders. However, not everyone finds the metaphor so useful. For some, the entity concept gets in the way of understanding the true dynamics of the firm:[191] only by recognizing that the firm is actually a complex set of relationships among individuals can the law deal adequately with the phenomenon.[192]

According to the law and economics movement, the corporation is best understood as a "nexus of contracts" — a web of interrelated contracts among individuals.[193] Under this theory, all relationships with the corporation are understood to be contractual in nature, whether explicitly or implicitly so. Each of the various stakeholders contribute certain inputs in exchange for certain rights with respect to outputs. The details of the contribution and return depend on the contract.

The shareholder, for example, is not the owner of the corporation in any meaningful sense.[194] Rather, the shareholder is better understood as an investor.[195] She contributes cash in exchange for the right to the residual profits of the business. The shareholder is not very different from the bondholder,[196] who also contributes cash in exchange for interest payments. The difference is in the terms of their contracts: where the shareholder has the right to all the residual profits of the business, if any, the bondholder has the right to receive a specified return, and no more. The bondholder's investment is similar to the shareholder's, but less risky.

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[190] This is not a new insight of the contractarians. *See* Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819).

[191] *See, e.g.*, Jensen & Meckling, *supra* note 165, at 310-11 ("[M]ost organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.") (emphasis and citation omitted).

[192] *See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1524-25 (1982).

[193] *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794-95 (1972); Jensen & Meckling, *supra* note 165, at 310-11.

[194] *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289-90 (1980).

[195] *See* Alchian & Demsetz, *supra* note 193, at 789 n.14.

[196] *See id.*

The contractarian perspective extends far beyond security holders, however. In a very real sense, all stakeholders can be seen as investors.[197] Employees, for example, make a contribution — of labor rather than cash — and receive the right to a certain return: a specified salary that is quite early in right of payment. Suppliers contribute materials, supplies, or equipment in exchange for a fixed payment. Customers contribute revenue in exchange for the product or service. Often, even the communities make a contribution of various civil services, and perhaps more concrete accommodations, such as infrastructure, in exchange for tax revenue and employment for its citizens.[198] Stakeholder relationships vary greatly. In each case, however, contractarian theory holds that the proper way to understand the relationship is as a contractual one.

According to contractarian theory, the nature of corporate law should reflect the fact that the corporation is nothing more than a web of voluntary contractual relationships. Rather than focusing on regulating the conduct of the various stakeholders, the goal of corporate law should be to facilitate transactions among them.[199] Thus, corporate law should not be seen as a collection of mandatory rules, but rather as a set of enabling statutes that empower stakeholders to enter into contractual relationships.[200] Stakeholders can structure their particular relationships as they see fit.

Ideally, contractarians would have no corporate law at all: freedom of contract would reign.[201] Realistically, however, corporate law is indispensable. Thus, the primary purpose of corporate law should be to minimize transaction costs so that everyone can enter into desirable transactions as efficiently as possible.[202] The law can help to eliminate various types of transaction costs, but it is particularly well-suited to eliminate one recurrent type: the inability to negotiate complete contracts. "Given bounded rationality, . . . it is impossible to deal with

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[197] *See* Klein, *supra* note 192, at 1526-33.

[198] *See* William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 415-16 (1990).

[199] *See* Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1536 (1989).

[200] *See generally* Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185 (1993).

[201] *See* Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 37 (1999); Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 284 (1991).

[202] *See* RALPH K. WINTER, GOVERNMENT AND THE CORPORATION 1 (1978).

complexity in all contractually relevant respects . . . ."[203] Even if it were possible to negotiate complete contracts, it would be expensive and inefficient to do so. The law facilitates contracting by providing default rules.[204] In this way, parties to a contract need not bother with excessive negotiations; they can be confident that, if some unanticipated event were to occur, the law would ensure a reasonable outcome.

In fact, under contractarian theory, corporate law is essentially a body of default rules around which parties to any particular transaction may contract.[205] The ideal corporate laws would be the most efficient default rules; the focus of legislatures and courts should be on enforcing those rules that the parties themselves would have entered into had they negotiated the matter.[206] Again, the idea is not to regulate, but rather to facilitate.

B. Shareholder Primacy Under Contractarian Theory

The ramifications of a move from the traditional view to contractarian theory would seem to be considerable. Not only are the shareholders no longer the owners, but they are reduced to an equal status with all other stakeholders. They have no more right to the corporation than anyone else — they have only those rights that are part of their contract with the firm.[207]

This would seem to open the door quite widely to the consideration of the interests of other constituencies: if the firm does not belong to the shareholders, then it should be managed in the interests of society as a whole.[208] However, contractarians generally are not fond of

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[203] Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1545 (1981).

[204] *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-45 (1989).

[205] *See id.*; *see also* ROMANO, *supra* note 3, at 1.

[206] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991). For a discussion of the hypothetical bargaining approach, see generally STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 29-31 (2002); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991).

[207] Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267-68 (1999).

[208] Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 833 (1999) ("[T]he nexus-of-contracts conception is connected in a fundamental way, not to shareholder primacy, but to a communitarian conception of the corporation in which all groups

concepts such as "social responsibility."[209] They cannot argue that the corporation exists for the benefit of shareholders, but they tend to end up in a position that is not far removed from the shareholder primacy of the traditional view.[210]

Although contractarians would agree that the corporation exists for the benefit of all its stakeholders, they would argue that the benefits come from the ability of each individual to enter into mutually beneficial contracts with others.[211] Contractarians generally do not believe that directors should be in the business of balancing the interests of the various stakeholders.[212] Directors have no special competence in doing so.[213] Such determinations are inherently political and inappropriate for actors who are not publicly accountable through democratic elections.[214] Allowing directors to balance competing interests enables them to advance their own interests by favoring, in any given situation, the stakeholder whose interest most closely matches their own.[215] Instead, a clear directive is necessary to hold directors accountable for the company's performance.[216]

How, then, can the corporation maximize societal welfare? The simple answer of the traditionalist — maximizing shareholder wealth — would seem to be inadequate because the interests of all stakeholders are equally valid. Thus, the contractarian answer is to focus on maximizing the aggregate wealth of all stakeholders (i.e.,

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with an interest in the corporation are put on an equal footing.").

[209] *See, e.g.*, Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1268-73 (1982).

[210] "[T]he efficiency [i.e., contractarian] model . . . rehabilitates the conclusions of the traditional model." Dallas, *supra* note 166, at 24.

[211] *See* Kenneth J. Arrow, *Social Responsibility and Economic Efficiency*, 21 PUB. POL'Y 303, 304-05 (1973).

[212] Contractarians are not entirely unanimous. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 288-89 (1999).

[213] *See* David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 29-34 (1979).

[214] *See* Friedman, *supra* note 162, at 124; *see also* Christopher J. Smart, Note, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301, 316-19.

[215] *See* EASTERBROOK & FISCHEL, *supra* note 206, at 38; Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 32 (1991).

[216] *See* CLARK, *supra* note 44, at 20-21; Comm. on Corp. Laws, ABA Section of Bus. Law, *Other Constituency Statues: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990).

maximizing societal wealth).[217] This would seem to be a daunting task, one beyond the ability of directors. Fortunately, there is a proxy for societal wealth: surprisingly enough, it is shareholder wealth.

The argument that shareholder wealth is a proxy for societal wealth is not based on the assumption that most members of society today are shareholders and, therefore, share in the corporation's profits.[218] Rather, it is based on the position of the shareholder as residual claimant. The interests of all other stakeholders are poor proxies for societal wealth because all other stakeholders have limited claims on the assets of the corporation. Because they will bear the downside of any risk without the ability to capture its upside potential, their incentive is to minimize risk to the corporation. The shareholder, however, is in a unique position. As residual claimant, she generally bears the entire weight of risk — both its upside and downside potential. If the risk leads the firm to make additional profits, it belongs to her; if the risk causes the firm to lose money, it comes from her profits. Accordingly, the shareholder's perspective is the best one from which to make wealth-maximizing decisions.[219]

Contractarians also tend to believe that maximization of shareholder wealth is the only viable goal given market forces. Competition in the products markets requires corporations to minimize production costs, while competition in the capital markets requires corporations to maximize shareholder returns.[220] Corporations that cannot compete in these markets will not thrive,[221] with a corresponding negative impact on all stakeholders.

Thus, under contractarian theory, the interests of the shareholder remain essential to corporate governance. However, this is true not because of the moral desert of the shareholder, but solely for

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[217] *See* BAINBRIDGE, *supra* note 206, at 20-23; Engel, *supra* note 213, at 34-35.

[218] *See, e.g.*, A.A. Berle, Jr., *For Whom Corporate Managers* Are *Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-68 (1932).

[219] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-06 (1983). There is a problem with shareholder incentives when the corporation is "in the vicinity of insolvency." *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ.A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991); *see also* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 223-24 (1999) (arguing ubiquity of "vicinity of insolvency" problem). However, even then, it is not the interests of other stakeholders that maximize societal wealth, but the interests of the corporation itself, or the residual interest divorced from its ownership.

[220] *See* WINTER, *supra* note 202, at 17-20.

[221] *See* MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 22 (1953); *cf.* Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950).

utilitarian reasons which benefit society. Directors are charged with the task of maximization of shareholder wealth not because they work for the shareholders, but because it is efficient. In fact, it is the default rule that everyone would agree to if negotiation over the issue were possible.[222]

C. Shareholder Rights Under Contractarian Theory

Given the contractarian premises, it is not difficult to see that the shareholder rights of electing directors and selling shares are important. In fact, these rights are important not only for the shareholder, but also for society generally. This section will explain how.

1. Shareholder Interests

On the simplest level, it can be argued that shareholder rights are important because the shareholder contract provides them with these rights. The concept of "shareholder" may not necessarily include the right to elect directors,[223] for example, but the existing contracts do so provide, and this is as worthy of respect as any other contractual term.[224] Just as it would not be permissible to rewrite the contract after-the-fact to the detriment of the customer, supplier, bondholder, or employee, neither should it be done for the shareholder. Shareholder rights presumably have been bargained for and should not be taken away, at least not without adequate compensation.

Ultimately, however, the existing contract argument is not fully satisfying. After all, the shareholder's contract includes a reserved right of the state to rewrite the corporate contract.[225] Although a limitless power to rewrite existing contracts may be of questionable legitimacy,[226] the law easily can be changed with respect to future corporations. Moreover, contractarians are more concerned with determining the appropriate default rules than with defending the rights of any particular parties. Therefore, it is necessary to establish

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[222] *See* Bainbridge, *supra* note 8, at 579; Macey, *supra* note 215, at 26-27.

[223] *See* Fama, *supra* note 194, at 291; Fischel, *supra* note 209, at 1276-77.

[224] *See* Easterbrook & Fischel, *supra* note 204, at 1446-47.

[225] *See* DEL. CODE ANN. tit. 8, § 394 (2006); MODEL BUS. CORP. ACT § 1.02 (2004).

[226] For arguments that amendment of state corporate law raises constitutional issues, see generally Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989); Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1 (1998).

that the rights of voting and selling shares are important aspects of the shareholder contract.

This is most obviously true with respect to the right to sell shares. If the shareholder is an investor like any other, then she should be free to divest herself of her investment as freely as anyone else. Restraints on alienation of stock would be no more legitimate than would restraints on alienation of debt securities. In fact, it would be like requiring an at-will employee to remain on the job when she would prefer to quit. If contracts are voluntary arrangements, shareholders should not be compelled to remain investors in the corporation, nor should they be prohibited from obtaining an available return on their investment.

The right to elect directors is also important to the shareholder contract. Shareholders are, in some respects, the most vulnerable of stakeholders.[227] They have no guaranteed return, only the right to residual profits. They also have few other contractual rights: by contrast, the bondholder has a comprehensive indenture, employees may have collective bargaining agreements, and the community has society's lawmaking powers at its disposal.[228] Complete contracts are particularly ill-suited to protect shareholder rights because directors need, and everyone wants them to have, flexibility to make wealth-maximizing business decisions.[229] With especially incomplete contracts, shareholders depend upon directors to protect their interests.[230] The right to elect directors is the most important means of keeping them accountable for the fulfillment of the terms of the shareholder contract.[231] Thus, the rights to elect directors and to sell shares are both of utmost importance to the shareholder.

2. Societal Interests

Under contractarian theory, the rights of the shareholder to elect directors and to sell shares are important not only to the shareholders themselves, but also to the other stakeholders. This is because granting these rights to the shareholders serves the societal goal of

[227] *See* Bainbridge, *supra* note 179, at 1442-45; Macey, *supra* note 215, at 36-39.

[228] *See* Bainbridge, *supra* note 179, at 1443-44.

[229] *See* Fischel, *supra* note 209, at 1264; Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367, 367-68 (1983).

[230] *See* Bainbridge, *supra* note 8, at 585-91; Jonathan R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L.J. 401, 407 (1993).

[231] *See* Easterbrook & Fischel, *supra* note 219, at 401-02.

keeping directors accountable. This accountability to shareholders does more than just protect shareholder interests; it also ensures that the corporation is managed in the interests of society.

The contractarian explanation of how shareholder rights work to keep directors accountable to society begins not with the right to elect directors, but with the right to sell shares. This is because contractarians are willing to accept the notion that shareholders are rationally apathetic. Shareholders are not interested in voting or attempting to control the corporation; rather, if they are dissatisfied with a corporation's policies or performance, they follow the "Wall Street rule" — they sell shares.[232]

This willingness of the shareholders to sell shares when dissatisfied creates what has come to be known as the "market for corporate control."[233] When shareholders are dissatisfied with corporate performance, the selling pressure will drive down the price of the company's stock. The resulting low stock price makes an acquisition of the company relatively inexpensive, leaving the company vulnerable to a hostile takeover.[234] Conversely, when shareholders are satisfied with a corporation's performance, there will be greater demand for the company's stock among potential investors. This buying pressure will be reflected in a high stock price, which in turn makes an acquisition of the company relatively expensive. Under such circumstances, the company is not particularly vulnerable to a hostile takeover.[235] In other words, if management is efficient, it can count on job security; but if management is inefficient, the market for corporate control stands ready to eliminate and replace them.

Fortunately, it does not take an actual hostile takeover for the market for corporate control to be effective. There also is a general deterrence effect. The mere risk of a hostile takeover usually will be sufficient to incentivize management to improve company performance.[236]

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[232] *See* sources cited *supra* note 98.

[233] *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965).

[234] *See* Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 111-13 (1989); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841-45 (1981).

[235] *See* Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1431 (1964).

[236] *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174 (1981).

Because the interests of the shareholders, as residual claimants, are a good proxy for the interests of society, the market for corporate control that makes directors accountable for maximizing shareholder wealth also works to keep directors accountable for maximizing societal wealth.[237] Thus, the right of shareholders to sell shares is an important tool to keep directors accountable to society — and this is especially true in the context of hostile takeovers.

The right to elect directors is a necessary companion to ensure accountability. Standing alone, it is fairly meaningless because of rational apathy. Similarly, the right to sell shares, standing alone, is fairly meaningless: shareholders have no direct control over the business or the directors, and this is as true for a sole shareholder as it is for public shareholders. Together, however, they allow dispersed shareholders to sell shares to a hostile bidder who then can replace management.[238] Ultimately, what prevents directors from ignoring shareholders is the threat of removal. The threat may be rather insignificant when made by public shareholders, but it is quite significant when made by a hostile bidder. Whereas public shareholders may be rationally apathetic, a sole or majority shareholder would not be. The successful hostile bidder would have the motivation to remove directors, and the right to elect directors gives them the ability to do so.[239]

Thus, the shareholder's rights to elect directors and to sell shares work together to create and sustain the market for corporate control. This keeps directors accountable for maximizing societal wealth. That shareholders also benefit from their ability to keep directors accountable to themselves is merely fortuitous.

V. SOCIAL RESPONSIBILITY THEORY

In this Part, I consider the fundamental rights of the shareholder from the perspective of the third major competing theory of the corporation, which focuses on corporate social responsibility. This final perspective is undeniably less supportive of shareholder rights than the previous perspectives because it is premised on the rejection of shareholder primacy. Some scholars do not believe that the corporation exists solely, or even primarily, for the benefit of its shareholders; they insist that there are other values that the

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[237] *See* EASTERBROOK & FISCHEL, *supra* note 206, at 38-39.

[238] *See* Butler, *supra* note 234, at 111; Easterbrook & Fischel, *supra* note 219, at 406.

[239] *See* Winter, *supra* note 2, at 276-77.

corporation and corporate law must serve. This general perspective can be called "social responsibility theory." Social responsibility theorists tend not to be very sympathetic towards shareholder rights. Theoretically, they might be willing reject the rights of the shareholder altogether. However, such an extreme position does not naturally follow from the perspective of corporate social responsibility, and few scholars would go so far.

Nevertheless, my goal in this part is necessarily modest. I argue only that social responsibility theory is not inherently inconsistent with the fundamental rights of the shareholder. Social responsibility theorists tend to focus on what distinguishes them from others and, therefore, downplay legitimate shareholder interests. By emphasizing that shareholders are important participants in the corporate enterprise, I hope to establish that their rights — especially their most fundamental rights — deserve no less respect than any other participants' rights.

My analysis begins with the observation that social responsibility theory is not monolithic. This is because it is inherently a complementary theory. It responds to prevailing notions of corporate law and adapts to changes over time.[240] Thus, it is not sufficient to focus on social responsibility theory generally; specific manifestations of the theory must be addressed as well. Accordingly, in section A, I begin with some general observations on the relationship between social responsibility theory and the fundamental rights of the shareholder. Then, in section B, I consider progressive corporate law (also known as communitariansim), which is social responsibility theory's response to contractarian theory. Next, in section C, I consider the concession theory, which is social responsibility theory's response to the traditional view. Finally, in Section D, I consider the claim that corporate law has been altered radically by the adoption of constituency statutes that allow directors to consider nonshareholder interests in making business decisions, which is social responsibility theory's response to legal formalism. Essentially, my argument throughout this Part is that social responsibility theory does not provide a principled basis for rejecting the fundamental rights of the shareholder.

[240] *See* C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 80-81 (2002).

A. Social Responsibility Theory Generally

Before turning to the various manifestations of social responsibility theory, I would like to make a few general observations. The following six points apply to social responsibility theory generally. They should be kept in mind throughout the remainder of this Part.

First, the various arguments raised throughout this Article deserve consideration in connection with social responsibility theory. The formalist claims of consistency, the traditionalist claims of property rights, and the contractarian claims of efficiency should not be forgotten. Indeed, because social responsibility theory is essentially responsive to these other theories, it must take their arguments seriously. Although such arguments may not be decisive for the social responsibility theorist, they should serve to mitigate any tendency to denigrate the legitimate rights of the shareholder.

Second, despite the insinuation, formalists, traditionalists, and contractarians do not consider themselves to be socially irresponsible. They all tend to believe that their theories are perfectly consistent with societal welfare. Traditionalists, for example, would argue that market forces ensure that society benefits when individuals pursue selfish goals.[241] Similarly, contractarians would argue that, because shareholder wealth is a strong proxy for societal wealth, society benefits from the shareholder primacy norm.[242] Formalists, on the other hand, would argue that respect for the rule of law is itself a societal good. Thus, the social responsibility theorist cannot rule out the positions of the formalist, the traditionalist, or the contractarian as intrinsically incompatible with societal welfare.

Third, the goal of this article is to defend the fundamental rights of the shareholder — not shareholder primacy, however closely related they may seem. Shareholder rights can coexist with a socially responsible board of directors. The right to elect directors does not amount to a right to direct them; directors remain free to exercise their own judgment on business matters, which they may do in a socially responsible manner.[243] In fact, shareholder voting rights arguably can serve to legitimize socially responsible behavior by the board. Of course, as a practical matter, shareholder rights may put a limit on directors' ability to attend to nonshareholder interests — but only to the extent that they harm shareholder interests, which also are legitimate. Rational apathy suggests that shareholders are unlikely to

[241] *See infra* notes 275-77 and accompanying text.
[242] *See supra* notes 217-22 and accompanying text.
[243] *See supra* notes 164-73 and accompanying text.

get involved in business affairs except in extreme situations,[244] so the effect of strong shareholder rights is not likely to be as hostile to corporate social responsibility as feared.

Fourth, the importance of the shareholder should not be underestimated. Without equity investors, there is no company. This argument should not be overstated because it also could be made of other stakeholders, such as employees. However, corporate governance rules are much more likely to result in a decreased willingness to invest on the part of shareholders than a decreased willingness to work on the part of employees. Thus, if only because of the relative economic positions of investors and employees, corporate governance rules that are shareholder-unfriendly are more likely to have a negative impact on the national economy than would rules that are shareholder-friendly. To the extent equity investment is made unattractive, there will be less of it. As a result, there will be fewer and smaller firms and a corresponding decrease in the benefits they provide to society. In short, lack of respect for the fundamental rights of the shareholder may not be the best way to promote the interests of society.

Fifth, it seems fair to acknowledge that, at root, social responsibility theory is more aspirational than practical. To be a meaningful concept, social responsibility must extend beyond legal requirements — and thus, by definition, cannot be legally enforceable.[245] Social responsibility, then, is more of an exhortation than a command. In truth, most shareholders probably are receptive to the message of social responsibility. Any discomfort likely stems from the prospect of being forced to sacrifice disproportionately for someone else's version of the greater good. This is especially so when it is difficult to escape the conclusion that, in the end, the beneficiary will not be society, but a self-serving management.[246]

Finally, it cannot be denied that social responsibility theory has been successful on one very important front: it has managed to persuade much of society — including directors and even shareholders — that many conflicts between shareholders and nonshareholders arise only from a short-term perspective, and that their interests may merge in a long-term perspective because of the benefits of harmonious and productive relationships.[247] Indeed, it has

[244] *See supra* note 44 and accompanying text.

[245] *See* Engel, *supra* note 213, at 5-11.

[246] *See supra* notes 215-16 and accompanying text.

[247] *See* CLARK, *supra* note 44, at 681-84; William T. Allen, *Our Schizophrenic Conception of the Corporation*, 14 CARDOZO L. REV. 261, 272-73 (1992).

also managed to persuade most people — in theory, at least — that the long-term perspective is the appropriate benchmark. Thus, concern about conflicting interests may be overstated; the conflict may not be as severe as often imagined and might be resolved better by a long-term approach to shareholder interests than by a paradigm of conflicting interests that need to be mediated.

B. Contractarian Theory and Communitarianism

Contemporary social responsibility theorists are often referred to as "progressive corporate law scholars" or "communitarians."[248] Communitarians insist that corporations have political and social dimensions as well as the obvious economic dimension.[249]

> Where contractarianism finds its legitimacy in the values of liberty and competition, communitarians emphasize justice and cooperation. Where contractarians to Adam Smith's invisible hand for a social welfare logic to justify the distribution of gains from corporate activity, communitarians yearn for an authentic community where the fulfillment of the true needs of society's members justifies corporate activity. Focusing on the managerial means to achieve corporate ends, contractarians invoke norms of freedom, while communitarians emphasize responsibility.[250]

"In contrast to contractarians, 'communitarians' . . . [believe] that corporate law must confront the harmful effects on nonshareholder constituencies of managerial pursuit of shareholder wealth maximization."[251] Despite the rhetoric, communitarians do not truly reject contractarian theory; to the contrary, their theory builds upon it.

As previously discussed, contractarian theory views the corporation as a web of interrelated contracts.[252] Shareholders are no more or less important that any of the other parties to the corporate contract. They have no special claim to the corporation; their rights are defined by

[248] *See* Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 UC DAVIS L. REV. 667, 674-76 (2002).

[249] *See* Hazen, *supra* note 201, at 278.

[250] Bradley et al., *supra* note 201, at 42.

[251] David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1378-79 (1993).

[252] *See supra* Part IV.A.

contract.[253] Communitarians generally accept this description of the firm. However, they do not accept the structure of shareholder primacy that contractarians tend to build on this foundation.

To defend the concept of shareholder primacy, contractarians cannot rely on metaphysics or morality. Rather, they must rely on two types of arguments: that shareholder rights are the results of voluntary bargains among corporate constituents and have been paid for by shareholders,[254] and that shareholder rights are efficient because they lead to the best use of resources and therefore maximize societal wealth.[255] Communitarians can respond on either front. They can reject the legitimacy of existing bargains by reference to power imbalances that make voluntary contracting impossible.[256] They also can reject the claims of efficiency made on behalf of shareholder primacy by denying the strength of the link between shareholder wealth and societal wealth or by insisting that the appropriate calculus of social welfare includes more than wealth.[257]

The communitarian spin on contractarian theory is that the corporation must be run consciously in the interests of society as a whole.[258] Their proposals for reform vary, but tend to deal with the role of directors. Some would give other stakeholders a right to representation on the board of directors.[259] Others would focus on recharacterizing directors as agents of the entire corporation — by which they mean all of its stakeholders — rather than of the shareholders alone.[260] Anything that would make directors expand their consideration beyond shareholder wealth maximization would seem to be worthy of consideration.

In order to justify enhanced rights for nonshareholders, communitarians often focus on a theory of implicit contracts.[261] The

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[253] *See supra* note 207 and accompanying text.

[254] *See supra* Part IV.C.1.

[255] *See supra* Part IV.C.2.

[256] *See, e.g.*, Hazen, *supra* note 201, at 314-17 (discussing power model of corporate structure set forth in Dallas, *supra* note 166); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW 1, 7-9 (Lawrence E. Mitchell ed., 1995) (discussing unequal bargaining power).

[257] *See, e.g.*, Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87, 90, 96 (2005).

[258] *See id.* at 89.

[259] *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION 123-26 (1976); Dallas, *supra* note 166, at 107-14.

[260] *See, e.g.*, Blair & Stout, *supra* note 212.

[261] *See generally* Sherwin Rosen, *Implicit Contracts: A Survey*, 23 J. ECON. LIT. 1144

web of contracts, it is said, extends beyond explicit, written contracts to include implicit, unwritten contracts. Employment is the example commonly used to illustrate the point. It is often argued that, in order to recruit a strong workforce, the company implicitly promises candidates certain benefits, such as job security. In reliance on that promise, employees invest in firm-specific capital which benefits the company and, indirectly, the shareholders. Given that promise, it would be inappropriate for the company to harm its employees — such as by reducing the workforce — in order to benefit shareholders.[262]

There are a number of problems with this type of argument. First, implicit contracts are not intended to be legally enforceable.[263] Thus, they can form the basis of a moral claim or a practical argument, but not a legal right. Second, one can question whether there is, in fact, an implicit contract. Have employees really been promised job security? Whether or not this was the case historically, it is not clearly the case in light of today's competitive labor markets and highly mobile workforce. Third, one can question the extent to which there is consideration for such implicit contracts. Do employees truly invest in firm-specific capital? It is not entirely clear that most employees do — at least not in a sufficiently meaningful sense.[264]

Finally, there is a reciprocity argument that should not be neglected. Just as employees invest in firm-specific capital, so do employers invest in formal and informal employee training. It is not clear why one investment should be deemed to create an expectation interest and the other should not. The more reasonable interpretation is that neither does: the parties invest, to the extent that they do, not with the expectation of an enforceable right, but in order to facilitate a productive relationship. Employees invest in order to avoid termination and hopefully advance their careers, while employers invest in order to enhance corporate productivity. This does not

(1985).

[262] *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 9, 23-24 (1986); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1206-07 (1991).

[263] *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1549-50 (1989).

[264] *Cf.* Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law*, 43 VILL. L. REV. 741, 817-18 (1998) ("Many employees simply do not have significant firm-specific human capital that is subject to expropriation. With regard to such employees, there are no implicit contracts to be breached.").

change the at-will nature of the relationship: employees expect to retain the right to quit, and employers expect to retain the right to fire.

This critique of implicit contract theory should provide a counterweight to the tendency of communitarians to exalt the rights and interests of nonshareholders over those of shareholders. Communitarians believe that contractarians focus on shareholders to the exclusion of other stakeholders. By focusing on the other stakeholders, communitarians believe they have a better appreciation of the big picture. However, by losing sight of the shareholders, they also fail to see the entire picture.[265] Ultimately, communitarians must admit that shareholders form part of the community that makes up the corporation. Even if they deserve no special consideration, shareholders deserve no less respect for their rights than do others. And those rights that are most fundamental deserve the greatest respect.

Thus, the right to sell shares represents the shareholders' right to exit their relationship with the company. This is a right that most participants would consider important.[266] To be fair, communitarians have no interest in limiting shareholders' right to sell shares in the open market. However, even a restriction limited to the context of hostile takeovers is significant. Shareholders are understood to invest primarily with a profit motive. The right to sell in a tender offer allows the shareholder the best opportunity to make a profit. It is the same type of opportunity that employees seek when leaving for a higher-paying job. Neither opportunity should be denied.

Communitarians may point out that, in takeover situations, there is a need to limit shareholder freedom because the impact of the collective action makes the exit particularly harmful to nonshareholder interests.[267] However, the same could be said of other participants. For example, a mass exodus by employees — even only a temporary one, as in a strike — can have a similarly harmful effect on nonemployee interests, but that does not make it inappropriate or justify a prohibition.

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[265] Of course, not all communitarians can be accused of losing sight of the shareholders. *See, e.g.*, Greenfield, *supra* note 257, at 93-95 (discussing importance of wealth creation).

[266] The right to exit is not equally important to all stakeholders. Communities, for example, are not typically interested in the right to eliminate businesses. However, they may be interested when it comes to undesirable businesses or for zoning purposes.

[267] *See* Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism Be Compassionate?*, 43 U. TORONTO L.J. 315, 317-25 (1993).

In truth, it is not the right to exit, but rather the right to elect directors, that is the true concern of communitarians. However, the right to elect directors also is important to shareholders because it represents the right to exert some control over their relationship with the corporation. It is analogous to the employees' right to collective bargaining or the lender's right to negotiate covenants. In fact, it is more important to the shareholders because of their status as residual claimants.[268] Unlike other stakeholders, who tend to have fixed claims, shareholders depend upon the loyalty of directors to protect their interests.[269] In such a dependant relationship, accountability is a crucial right.

Of course, because communitarians place a high value on the ability to control the direction of the corporation, it is unlikely that they would yield very easily on the issue of shareholder voting rights. Nevertheless, the interests of the shareholders are strong, and their rights should not be ignored. And even if the shareholder's right to elect directors is somewhat curtailed, the right to sell shares can and should remain inviolate.

C. Traditional View and Concession Theory

Social responsibility theory began in earnest in the 1930s. Columbia Law School Professor Adolf A. Berle, Jr., and Harvard Law School Professor E. Merrick Dodd, Jr., debated the issue in the *Harvard Law Review*.[270] While Berle defended the traditional view, Dodd argued for greater social responsibility on the part of corporations and corporate management.[271]

Early social responsibility theorists advanced what would come to be known as the concession theory.[272] "Concession theorists argue

[268] *See supra* note 219 and accompanying text.

[269] *See supra* notes 227-31 and accompanying text.

[270] *See* Berle, *supra* note 218; Dodd, *supra* note 162, at 1160-61; *see also* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

[271] Ironically, both scholars ended up backing off their positions somewhat. *See* A.A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1935); *see also* Wells, *supra* note 240, at 101-05.

[272] Actually, concession theory originated as a theory of the firm that was used to limit corporate powers out of fear. *See also* Paul G. Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873 (2000). *See generally* Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 181, 186-88 (1985). Social responsibility theorists later used the theory's premise in order to expand the corporations' power out of hope.

that corporations exist at the sufferance of the government, which retains a legitimate role in conditioning its grant of a corporate charter (viewed as the concession of the government) on the receipt of some quid pro quo."[273] Typically, what concession theorists seek in return is socially responsible behavior.

The concession theory was rooted in the traditional view. Concession theorists accepted the notion that shareholders were owners of the corporation; however, this did not lead them to the same conclusions that traditionalists espoused.[274] In particular, many traditionalists have argued that the corporation must be run solely for the benefit of its shareholders. According to them, the only social responsibility of the corporation, aside from maximizing shareholder wealth, is compliance with law.[275] Society is said to benefit from the selfish pursuits of individuals through the workings of the invisible hand.[276] Demanding self-sacrificing behavior, of shareholders or anyone else, is inappropriate and perhaps even detrimental.[277]

Concession theorists disagreed. They believed that there was, in fact, room for socially responsible behavior by corporations, just as there would be room for socially responsible behavior by individuals in the management of their personal affairs.[278] In fact, concession theorists went one step further. They argued that because incorporation bestows upon shareholders many benefits — with limited liability being only the most obvious[279] — the state had the right to expect something in return.[280] Double taxation could be considered one such demand.[281] Concession theorists, however, insist

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[273] *See* Michael E. DeBow & Dwight R. Lee, *Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation*, 18 DEL. J. CORP. L. 393, 397 (1993).

[274] *See* Dodd, *supra* note 162, at 1145-48.

[275] *See* Freidman, *supra* note 162, at 124.

[276] *See generally* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

[277] *See* Eugene V. Rostow, *To Whom and for What Ends Is Corporate Management Responsible?*, *in* THE CORPORATION IN MODERN SOCIETY 46, 63-69 (Edward S. Mason ed., 1959).

[278] *See* Dodd, *supra* note 162, at 1157, 1160-61; Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1416-17 (1993).

[279] *See* Green, *supra* note 278, at 1415.

[280] *See* Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327, 1327-28 (1979).

[281] Double taxation is often considered to be the "price" of limited liability. *See* R. GOODE, THE CORPORATE INCOME TAX 27-30 (1951). However, the history does not necessarily support the linkage. *See* Philip I. Blumberg, *Limited Liability and Corporate*

that the state has the right to demand socially responsible behavior as well.

Of course, the validity of the concession theory depends upon the existence of a concession. Where incorporation once was a special privilege, it is now a universal right.[282] To many, the notion of a concession seems antiquated and inaccurate.[283] Even if one accepts the theory, however, it is fair to insist that the state only make demands commensurate with the concession. If not much is conceded, then little can be expected in return. Thus, if the state will not respect even the fundamental rights of the shareholder, then even minor demands could seem illegitimate.

Because concession theory is rooted in the traditional view, it recognizes the ownership interest of the shareholder.[284] While this does not necessarily resolve any particular question, it does suggest that strong shareholder rights at least should be the null hypothesis. Unless there is an adequate justification, shareholders would seem to be entitled to the same rights as other property owners.

This argument clearly supports a strong right to sell shares: it seems unfair to prevent the corporation's owners from selling their interests freely. Even with respect to hostile takeovers, it seems unfair to prevent the owners, as a group, from selling their business. In fact, the right to sell is the right that shareholders consider most important.[285] If this right is not protected, then the "concession" theory becomes strained.

A strong right to elect directors is slightly more difficult to defend against the concession theory. After all, what social responsibility theorists want is socially responsible behavior and, while that may have little to do with ownership, it has quite a bit to do with control. To the extent that directors are accountable to shareholders, they may tend to ignore the interests of nonshareholders.[286] Even if directors are permitted by law to engage in socially responsible behavior, they may fear retaliation for acting against the interests of the shareholders

Groups, 11 J. CORP. L. 573, 577-605 (1986).

[282] *See* David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 205-32.

[283] *See, e.g.*, Gary M. Anderson & Robert D. Tollison, *The Myth of the Corporation as a Creation of the State*, 3 INT'L REV. L. & ECON. 107, 109 (1983).

[284] *See, e.g.*, Dodd, *supra* note 162, at 1145-46 (acknowledging rights of shareholder as owner).

[285] *See supra* notes 97-98 and accompanying text.

[286] *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1001 (1992).

who elect them. Thus, it may make sense for concession theorists to seek to make directors less accountable to shareholders.[287]

Reducing directors' accountability to shareholders, however, is not much of a solution. Such a move would increase the ability of directors to behave opportunistically without increasing their incentives to attend to nonshareholder interests.[288] Society stands to gain little, and shareholders to lose much, from lower accountability at the margins. While a more radical corporate governance solution might be capable of providing greater societal benefits, such a proposal would be unlikely to gain broad support and actually might be illegitimate when viewed as a "concession." In any event, even if the concession theory would support some limitations on the shareholder right to elect directors, it would not justify any interference with the shareholder right to sell shares.

D. *Formalism and Constituency Statutes*

The social responsibility theorist's response to the corporate law formalist would be to point to the widespread adoption of what have come to be known as constituency statutes.[289] Such statutes represent social responsibility theory's greatest legal success. They generally authorize directors to take into consideration not only the interests of shareholders, but also the interests of other stakeholders. Although the statutory language varies from state to state, Florida's constituency statute can serve as a typical example:

> In discharging his or her duties, a director may consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and the nation.[290]

[287] *See* Lawrence E. Mitchell, *A Theoretical Model for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 582, 606-07 (1992).

[288] *See supra* notes 215-16 and accompanying text.

[289] These statutes are known by many different names. *See* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 16-17 (1992). The term "constituency statutes" was selected for its simplicity and purported neutrality. *See id.* at 18.

[290] FLA. STAT. § 607.0830(3) (2006).

Many have claimed,[291] and others have feared,[292] that these statutes reflect a legislative repeal of the norm of shareholder primacy. While, at first glance, constituency statutes seem quite promising for the social responsibility theorist, upon closer examination, they are rather disappointing. At least with the benefit of hindsight, it seems clear that constituency statutes are not very significant.

In the first place, the adoption of constituency statutes has been hardly universal. While it is true that twenty-nine states have one form or another of constituency statute in effect,[293] there remain twenty-one states that do not. Significantly, Delaware — by far the most important state in terms of corporate law — has not adopted a constituency statute.[294] Thus, it is misleading to suggest that constituency statutes are standard in corporate law.

In addition, constituency statutes tend to be quite limited in scope.[295] They generally provide only that directors *may consider* the interests of nonshareholders. Only Connecticut's statute requires

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[291] *See, e.g.*, David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 242-43 (1991); Mitchell, *supra* note 287, at 582, 640.

[292] *See, e.g.*, Comm. on Corp. Laws, *supra* note 216, at 2253; James J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Come*, INSIGHTS, Dec. 12, 1989, at 20, 22.

[293] *See* CONN. GEN. STAT. § 33-756(d) (2004); FLA. STAT. § 607.0830(3); GA. CODE ANN. § 14-2-202(b)(5) (2006); HAW. REV. STAT. § 414-221(b) (2005); IDAHO CODE ANN. §§ 30-1602, 30-1702 (2006); 805 ILL. COMP. STAT. 5/8.85 (2006); IND. CODE § 23-1-35-1 (2006); IOWA CODE § 491.101B (2006); KY. REV. STAT. ANN. § 271B.12-210(4) (West 2005); LA. REV. STAT. ANN. §12:92(G) (2006); ME. REV. STAT. ANN. tit. 13-C, § 831(6) (2006); MASS. GEN. LAWS ch. 156D, § 8.30 (2006); MINN. STAT. § 302A.251(5) (2006); MISS. CODE ANN. § 79-4-8.30(f) (2006); MO. REV. STAT. § 351.347 (2006); NEV. REV. STAT. § 78.138 (2005); N.J. STAT. ANN. § 14A:6-1 (2006); N.M. STAT. ANN. § 53-11-35(D) (West 2006); N.Y. BUS. CORP. LAW § 717(b) (Consol. 2006); N.D. CENT. CODE § 10-19.1-50(6) (2005); OHIO REV. CODE ANN. § 1701.59(E) (2006); OR. REV. STAT. § 60.357(5) (2005); 15 PA. CONS. STAT. §§ 515-17, 1711-12, 1715-17 (2006); R.I. GEN. LAWS § 7-5.2-8 (2005); S.D. CODIFIED LAWS § 47-33-4 (2006); TENN. CODE ANN. § 48-103-204 (2006); VT. STAT. ANN. tit. 11A, § 8.30(a) (2005); WIS. STAT. § 180.0827 (2006); WYO. STAT. ANN. § 17-16-830(e) (2005). A few additional states have statutes that allow the board to consider the long-term interests of the corporation, but do not specifically refer to nonshareholder interests. *See* ARIZ. REV. STAT. § 10-2702 (LexisNexis 2006); TEX. BUS. CORP. ACT ANN. art. 13.06 (Vernon 2006); VA. CODE ANN. §§ 13.1-727.1 (2006). Nebraska had enacted a constituency statute, but then repealed it. *See* NEB. REV. STAT. § 21-2035 (1994) (repealed 1995).

[294] *But see infra* notes 303-06 and accompanying text (describing substantially similar case law).

[295] For a thorough analysis of the various constituency statutes that remains relatively accurate, see generally Jonathan D. Springer, *Corporate Constituency Statutes: Hallow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85 (1999). *See also* Orts, *supra* note 289.

directors to do so.[296] None of the statutes indicates how much weight should be given to the various interests. In fact, only a few statutes state that shareholder interests need not be the dominant consideration.[297] None of the statutes explicitly create enforceable rights on the part of nonshareholders, and some explicitly deny such rights.[298] These facts are not indicative of a legal revolution favoring nonshareholders.

Finally, history has proven such statutes to be rather insignificant. Cases involving constituency statutes have been few and far between, and they rarely, if ever, hinge upon such provisions.[299] More importantly, there is no evidence that constituency statutes have had any effect on director behavior.[300] In light of the foregoing, it would be specious to argue that constituency statutes have effected a fundamental change in corporate law. Thus, an expansive interpretation would seem wholly inappropriate in most states.[301]

In contrast, some commentators have suggested a minimalist interpretation.[302] One such interpretation borrows from Delaware. Although Delaware does not have a constituency statute, its common law has a similar provision. In *Unocal Corp. v. Mesa Petroleum Co.*,[303] the Delaware Supreme Court noted that directors, in reacting to a hostile takeover attempt, may consider, among other factors, "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[304] However, a few months later, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[305] the same court provided a crucial limit: "[W]hile concern for various corporate constituencies is

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[296] *See* CONN. GEN. STAT. § 33-756(d).

[297] *See* IND. CODE § 23-1-35-1(f); IOWA CODE § 491.101B(2); 15 PA. CONS. STAT. §§ 515(b), 1715(b).

[298] *See* GA. CODE ANN. § 14-2-202(b)(5); NEV. REV. STAT. § 78.138(6); N.Y. BUS. CORP. LAW § 717(b); 15 PA. CONS. STAT. §§ 517, 1717.

[299] *See* Springer, *supra* note 295, at 108-20.

[300] The one exception might be the arguments that directors use to justify their actions.

[301] *See* Orts, *supra* note 289, at 79-84.

[302] *See, e.g.*, Comm. on Corp. Laws, *supra* note 216, at 2269 ("The Committee believes that the better interpretation of these statutes . . . is that they confirm what the common law has been: directors may take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation.").

[303] 493 A.2d 946 (Del. 1985).

[304] *Id.* at 955.

[305] 506 A.2d 173 (Del. 1986).

proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders."[306] This position reflects a socially responsible perspective while respecting the ultimate primacy of the shareholder. As such, it could reconcile the text of many constituency statutes with the overall sense of corporate law.

Although a minimalist interpretation may seem suspect,[307] it makes sense on many levels. First, it is more consistent with history as well as current trends in corporate law than a more expansive reading.[308] Second, it would provide a workable framework for application. An open-ended authority to consider various constituencies provides no guidance either to directors in making business decisions or to courts in reviewing director action for breach of fiduciary duties.[309] Third, it would comport with the norm of statutory construction that statutes in derogation of the common law should be construed narrowly.[310] It seems fair to demand a clear signal from the legislature before interpreting a statutory provision to effect a radical change. Few state legislatures have given such a signal. Finally, a minimalist interpretation could not be said to undermine the authority of the legislature.[311] Not all statutes are revolutionary; some are mere codifications of common law. At least when they are as ambiguous as most constituency statutes, courts must read statutes in context, both in terms of history and structure. Thus, the minimalist interpretation is not clearly unreasonable.

Historically, constituency statutes were adopted as antitakeover statutes.[312] In fact, many were adopted in response to particular takeover attempts.[313] Some are even explicitly limited to change of

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[306] *Id.* at 176.

[307] *See* Orts, *supra* note 289, at 72-79.

[308] *Cf.* Bainbridge, *supra* note 286, at 990 ("[I]n light of the traditional primacy of shareholder interests, this interpretation would amount to a total rejection of corporate law's basic normative principal."); Orts, *supra* note 289, at 79-84 (arguing against expansive interpretation).

[309] *See supra* notes 215-16 and accompanying text.

[310] *See* 3 NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 61:1 (6th ed., rev. 1991). *But see id.* § 61:4, at 247-48 ("The rule that statutes in derogation of the common law are to be strictly construed has been the object of a great deal of criticism in modern times.").

[311] *See* Millon, *supra* note 291, at 257.

[312] *See* Comm. on Corp. Laws, *supra* note 216, at 2253-54; David Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. & LEE L. REV. 903, 924-26 (1988).

[313] *See* John C. Anjier, *Anti-Takeover Statutes, Stakeholders, and Risk*, 51 LA. L. REV.

control situations.[314] Thus, it may be fair to read most constituency statutes as a form of antitakeover statute.[315] There are many possible ways of doing so. The minimalist interpretation would fit the bill, but in some states such an interpretation may be foreclosed.[316] A more generous interpretation might characterize the constituency statute as a "disabling" statute: corporate law generally is considered to be "enabling" in nature because it facilitates various corporate transactions, such as mergers; but it also can be used to prohibit certain corporate transactions, such as hostile takeovers. Under this interpretation, constituency statutes would not go so far as to forbid hostile takeovers, but only add something of a director approval requirement. While this may be an unwise decision for the various reasons presented in this Article, it would be neither illegitimate nor overly expansive.

Structurally, corporate law embodies the norm of shareholder primacy.[317] To be fair, it deals with the allocation of authority between shareholders and management as well as the accountability of management to shareholders — with the balance tipping decidedly in favor of management.[318] However, management owes fiduciary duties to the corporation and its shareholders. Attempts to interpret "the corporation" as meaning all of its stakeholders are primeval,[319] but have been more fanciful than successful. For one statutory provision to undermine the remainder of corporate law would be anomalous. It would be reasonable to avoid such an interpretation if at all possible.[320] Only in a few states would it be difficult to do so.

In any event, at least on their face, most constituency statutes are silent on the shareholder's rights to elect directors and to sell shares. They allow the directors discretion to manage the affairs of the

561, 578-79 (1990); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 134-38 (1987).

[314] *See* IOWA CODE § 491.101B (2006); LA. REV. STAT. ANN. § 12:92(G) (2006); MO. REV. STAT. § 351.347 (2006); OR. REV. STAT. § 60.357(5) (2005); R.I. GEN. LAWS § 7-5.2-8 (2005); S.D. CODIFIED LAWS § 47-33-4 (2006); TENN. CODE ANN. § 48-103-204 (2006).

[315] *See* Bainbridge, *supra* note 286, at 993; Orts, *supra* note 289, at 26.

[316] For example, Pennsylvania and Indiana explicitly reject Delaware precedent. *See* Springer, *supra* note 295, at 98-99. The Delaware interpretation also may be impossible in states where consideration of other constituents is mandatory, or where no stakeholders' interests may be considered dominant. *See supra* notes 296-97.

[317] *See supra* note 8 and accompanying text.

[318] *See* Bainbridge, *supra* note 8, at 568-73.

[319] *See* Dodd, *supra* note 162, at 1160.

[320] *See* Bainbridge, *supra* note 286, at 990.

business, but do not authorize directors to manage the affairs of the shareholders.[321] Thus, if the formalist argument prevails, constituency statutes have no impact on shareholder rights.

In all fairness, if constituency statutes essentially are antitakeover statutes, then they could be expected to have at least *some* effect on the shareholder's right to sell her shares in a tender offer. This would be unfortunate, but by no means illegitimate. However, constituency statutes should have absolutely no effect on the fundamental right to elect directors. In fact, even under the most expansive interpretations of constituency statutes, the right to elect directors remains intact.

CONCLUSION

The norm of shareholder primacy is not in much danger these days. However, the role of the shareholder in corporate governance is not well defined, and this puts shareholder rights at risk. In theory, few would deny the significance of the right to elect directors or the right to sell shares; in practice, however, these rights are subject to significant and arbitrary limitations. In this Article, I have defended the importance of protecting these fundamental rights of the shareholder from a variety of perspectives. My goal throughout this endeavor has not been to elevate the shareholders above the directors, but only to ensure respect for the role of each in corporate governance.

Shareholders should not be entitled to run the business. However, they should be entitled to sell shares freely. They also should be entitled to effective elections of directors. Once elected, directors should be free to run the business according to their best judgment (subject only to their fiduciary duties and limited statutory constraints). However, directors should not be permitted to interfere with the fundamental rights of the shareholder. Respecting these rights may have dramatic consequences — especially with respect to contests for corporate control — but this would not upset the balance of power between directors and shareholders. The freedom of the shareholders to elect the directors of their choice would not supplant the freedom of the new directors to run the business according to their best judgment.[322]

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[321] *See supra* note 124 and accompanying text.

[322] Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291-92 (Del. 1998) ("Section 141(a) . . . confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation.") (emphasis omitted).